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Supreme Court of the United States.

OCTOBER TERM, 1971.

No.

JOSEPH V. RAFFERTY AND
MARGARET M. RAFFERTY,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

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Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the First Circuit entered in the above case on December 6, 1971.

Opinions Below.

The opinion of the United States Tax Court is reported at 55 T.C. 490 (filed December 14, 1970) (Appendix 13). The opinion of the Court of Appeals for the First Circuit, filed December 6, 1971, is not yet officially reported (Appendix 33).

Jurisdiction.

The judgment of the Court of Appeals for the First Circuit was made and entered on December 6, 1971, and a copy thereof is appended to this petition in the Appendix 32. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

Questions Presented.

Respondent determined a deficiency in petitioners' Federal income tax for the year 1965 contending the distribution of all of the stock of Teragram Realty Company, Inc. (hereinafter Teragram) to petitioners by Rafferty-Brown Steel Company, Inc. (hereinafter RBS) constituted the distribution of a dividend. Petitioners contend that the distribution was one on which no gain or loss is recognized under the provisions of Sec. 355 of the Internal Revenue Code of 1954 (Appendix 35).

The questions presented therefore are:

1. Whether the First Circuit applied the proper legal criteria in determining that there was not a valid "business purpose" for the distribution and therefore that it was principally a "device" for the distribution of earnings and profits within the meaning of Sec. 355 (I.R.C. 1954);

2. Whether the leasing of real property to a related corporation constitutes the active conduct of a trade or business for purposes of Sec. 355;

3. Whether the First Circuit erred in not considering the purchasing, construction, mortgaging and leasing activity of Teragram in 1965 in its determination that Teragram had not been involved in the active conduct of a trade or business for a five-year period;

4. Whether the First Circuit applied the proper legal criteria in determining that Teragram was not engaged

in the active conduct of a trade or business for a five-year period.

Statutes and Regulations Involved.

Section 355 of the Internal Revenue Code of 1954, 26 U.S.C. 355, Section 112(b)(11) of the Internal Revenue Code of 1939, 26 U.S.C. Internal Revenue Code of 1939, and Income Tax Regulations, Section 1.355, C.F.R. Part 1, 1.301, are set forth in the Appendix 35-52.

Statement.

This case questions the applicability of Section 355 of the Internal Revenue Code of 1954 to transactions occurring between 1960 and 1965 involving corporations controlled by petitioners. The jurisdiction of the United States Tax Court was based upon 26 U.S.C. §§ 6213 and 7442.

The facts, some of which have been stipulated are as follows. Prior to June 1960, RBS, a Massachusetts corporation, the stock of which was and still is entirely owned by petitioners conducted a strip steel fabricating business in a multi-purpose building it owned located in East Longmeadow, Massachusetts. In May of 1960, at the suggestion of their tax advisor-accountant, petitioners caused RBS to create a wholly owned subsidiary, Teragram, also a Massachusetts corporation. In June of that year, RBS transferred its East Longmeadow real estate to Teragram in exchange for all of the latter's outstanding stock. Thereupon, Teragram leased this real estate back to RBS for 10 years at an annual rental of $42,000.

From its inception to date, Teragram collected rents, paid real estate taxes, maintained separate books and records and caused to be filed its own Federal and State tax re-

turns. Joseph V. Rafferty, the president and treasurer of both RBS and Teragram has been the guiding force behind both RBS and Teragram.

In 1962, the petitioners caused to be organized Rafferty-Brown Steel Company, Inc., of Connecticut (hereinafter RBS Conn.) which corporation acquired the assets of Hawkridge Brothers (Hawkridge), a general steel products warehouse in Waterbury, Connecticut. From its inception, the petitioners have owned all of the outstanding stock of RBS Conn. From 1962 to 1965, Hawkridge leased its real estate in Waterbury to RBS Conn. After negotiations, begun in 1964, Teragram, in 1965, purchased some unimproved real estate in Waterbury and built a plant there. It arranged for the construction and financing of this plant. The mortgage on the plant, on which Teragram was solely liable, was secured by both the East Longmeadow and the Waterbury properties. Teragram leased this Waterbury plant to RBS Conn. for a term of 14 years from November 1, 1965. Teragram continues to own and lease the Waterbury real estate to RBS Conn. and the East Longmeadow realty to RBS, which companies have continued to operate their businesses at these locations.

On various occasions prior to the incorporation of Teragram, petitioner consulted his accountant about planning his estate, particularly about the orderly disposition of RBS. While he anticipated that his sons would join him at RBS, he wanted to exclude his daughters (and/or his future sons-in-law) from the active management of the steel business. He wished, however, to provide his daughters with property which would produce a steady income independent of the steel business. The accountant recommended the formation of Teragram, the distribution of its stock and the eventual use of this stock as future gifts to the Raffertys' daughters. Petitioners acted on this advice

and also on the accountant's opinion that the distribution of Teragram stock would meet the requirement of Sec. 355.

In August of 1965, in accordance with the plan recommended by the accountant and more than five years after the entry of Teragram into the real estate business, for valid business reasons, as found by the trier of fact, Judge Dawson of the United States Tax Court, RBS distributed all of the Teragram stock to petitioners who continue to hold all the stock of RBS, RBS Conn. and Teragram.

Petitioners treated the distribution of the Teragram stock as a nontaxable transaction under Sec. 355. The respondent determined that the transaction did not meet the requirements of Sec. 355 and thus was a taxable dividend and, accordingly, asserted a deficiency against petitioners. He based his assertion on his view (a) that the petitioners failed to establish that the formation of Teragram and the distribution of its stock was for a valid business purpose, and (b) that Teragram was not engaged in the active conduct of a trade or business.

Judge Dawson, in the Tax Court, correctly framed the only two issues arising out of the application of Sec. 355 to this case.

The first issue is whether the instant transaction was "principally a device for the distribution of earnings and profits." In order to respond in the negative there has come, through judicial decisions, a requirement that there be a finding of a valid business purpose. The Tax Court found a "valid business purpose" both for the separation of Teragram and the distribution of its stock to petitioners. Petitioners' reasons for forming Teragram and having all its stock distributed to petitioners to facilitate the distribution of the Rafferty-Brown steel business assets among their children, were, in the words of the Court, not "naked, personal reasons of the petitioners, as respondent contends, [but] are very much intertwined with the most fundamental

of business purposes of the corporation, that of continuity of the corporate enterprise and retention of successful and seasoned management personnel and policies." (Appendix 23.)

The First Circuit disagreed with the Tax Court on this issue. It declared that ". . . no *immediate* business reason existed for the distribution of Teragram's stock to the taxpayers. . . . there was, at best, only an envisaged possibility of future debilitating nepotism. If avoidance of this danger could be thought a viable business purpose at all, it was so remote and so completely within the taxpayers' control that if, in other respects the transaction was a 'device,' that purpose could not satisfy the taxpayers' burden of proving that it was not being used 'principally as a device' within the meaning of the statute." (Emphasis added.) (Appendix 33–4, 5.) The Court then ruled that personal motives are not relevant "unless those motives are germane to the continuance of the corporate business." (Appendix 33–6.) Parenthetically Judge Dawson noted that petitioners' reasons were ". . . to insure the continued existence and success of RBS . . . ." (Appendix 23.)

This view of the law of Sec. 355 is in conflict with the First Circuit's own decision in *Lewis* v. *Commissioner of Internal Revenue*, 176 F. 2d 646 (C.A. 1, 1949) and the Second Circuit's decision in *Estate of Parshelsky* v. *Commissioner of Internal Revenue*, 303 F. 2d 14 (C.A. 2, 1962).

In *Lewis* the First Circuit stated: "To seek to differentiate between 'corporate purpose' and 'shareholder purpose' is unrealistic and impractical, particularly with respect to closely held corporations. . . . The separate legal identity of these corporations should not obscure the fact that they are operated by their shareholders in a manner thought best calculated to serve the latter's interests. What is deemed best for the shareholders is deemed best for the corporation, and vice-versa." (176 F. 2d 646, 650.)

In *Parshelsky, supra,* on facts substantially similar to the instant case, the Second Circuit held "that the Tax Court erred in this case when it examined only those reasons for the reorganization 'relating to the business being carried on by the corporation, or relating otherwise to the corporation's organization or functioning' and refused to examine those 'arising from and serving only the personal or noncorporate-business interests of the shareholders.'" "The benefits to the corporation and to the shareholders are virtually indistinguishable." (303 F. 2d 14, 19.)

The second issue in the Tax Court was whether Teragram met the "active trade or business" requirement of Sec. 355(b) IRC.

The Tax Court determined that this requirement was not met, citing Income Tax Regulation, Sec. 1.355-1(c) in support of that finding (Appendix 28-29).

It refused to consider as relevant to the question of whether Teragram was engaged in the active conduct of a trade or business the facts that, in the fourth and fifth years of its existence, Teragram arranged for the purchase of unimproved real estate, the construction of a plant thereon, the financing of that purchase and construction with a mortgage on which it was solely liable, and for which both its East Longmeadow and Waterbury real estate was security, and the leasing of that property (Appendix 29-32).

This case again conflicts with the opinion of the Second Circuit in *Parshelsky, supra.* In interpreting the phrase "active conduct of a trade or business" in the 1939 Code predecessor of Sec. 355, the Second Circuit found that "It is clear that acting as lessor of real property which is rented to others can constitute a trade or business . . . . Absent the limitations of the § 355 regulations, acting as lessor to a related corporation can also constitute an active trade or business within the meaning of § 112 (b) (11)." 303 F. 2d 14, 22.

As will be seen *infra,* those regulations have been criticized, not followed, and, indeed, declared invalid.

Reasons for Granting the Writ.

Sec. 355 was enacted in 1954 and is a very important provision in the planning and execution of business transactions; hence, it is critical that once and for all there be a definitive statement by this Court as to the proper tests to be applied. There is a lack of definitive interpretation of the meaning of the phrase "principally a device for the distribution of earnings and profits," what constitutes "the active conduct of a trade or business," and what is a proper "business purpose."

The decision below should be reviewed for a number of significant reasons.

1. With respect to the issue of whether the transaction was principally a device for the distribution of earnings and profits, the legal test applied by the First Circuit does not comport with the intent of the statute and with prior court decisions. It is clear that the statutory test is, was the transaction used or intended to be used to avoid or evade tax?

In the instance of a closely held corporation a determination as to the presence or absence of allowable tax avoidance requires an inquiry into the motives of the shareholders who are the alter ego of that corporation. This has been the test applied by the Second Circuit since the 1939 case of *Parshelsky, supra.* Indeed, the First Circuit has used the same test in *Lewis, supra.* In the instant case, the First Circuit has disregarded these precedents and sought to investigate the results of the shareholders' purpose on the corporations.

Even if this Court views this as a proper inquiry, the First Circuit has disagreed with the finding of the Tax

Court as to proper "business purpose" and has, in effect, imposed its own business judgment on these taxpayers in this case.

Thus, the lower courts, the taxpayers and the Commissioner need a guide as to the proper test of what constitutes a valid nontax business purpose.

2. The question of the meaning of the statutory language of the "active conduct of a trade or business" requires resolution.

This case arises in an extremely common commercial setting where a corporation owns valuable improved real estate and leases it on a so-called "net" lease basis to another taxpayer. The economic value to the lessor corporation of the "net" lease consists of being assured of a certain return on its investment, the avoidance of increased property taxes, maintenance labor costs, and maintenance supplies and equipment. The lessees of such property also benefit from this leasing structure in that they maintain complete day-to-day control over the property and can, therefore, operate the property and maintain plant security as they see fit. Lessors, of course, continue to bear the risks of the failure of their lessees and the destruction of their property.

Thus, it is urgent that the question of whether the net leasing of improved multi-purpose real estate constitutes the active conduct of a trade or business be answered.

3. A further question arises in this case and in *King* v. *Commissioner*, 55 T.C. No. 69 (filed January 28, 1971), on appeal to the Sixth Circuit. In both cases the property was leased to a related corporation. This likewise is a common occurrence because taxpayers often seek to insulate improved real property from the attendant risks of the operating business conducted therein. Thus, an answer to the

question of whether the net leasing of property to a related corporation takes the lessor out of the "active conduct of a trade or business" category is equally important.

The Commissioner of Internal Revenue has attempted to define and explain the term "active conduct of a trade or business" in his Income Tax Regulations, Sec. 1.355-1 (c) (Appendix 36-37). Several courts have declared those regulations invalid or inapplicable. *Coady* v. *Commissioner*, 33 T.C. 771 (1960), aff'd *per curiam*, 289 F. 2d 490 (C.A. 6, 1961) and *United States* v. *Marett*, 325 F. 2d 28 (C.A. 5, 1963), and in this very case, the First Circuit questioned the correctness of those regulations and refused to rely on them (Appendix 33–9-10).

Indeed, the Commissioner himself has recognized the need to modify those regulations, although he has not done so in eight years. Rev. Rul. 64-147, 1964-1 Cum. Bull. Pt. I, at 136.

These regulations were relied on recently by the Tax Court in the case of *King, supra*. The *King* case contains facts substantially the same as the instant case and the identical issue.

The situation created by the uncertainty of the validity of the Sec. 355 Regulations must be corrected. Only this Court can settle the controversy and provide guidance.

4. The First Circuit erred in failing, by its own admission, to take into account all relevant facts in its determination of whether Teragram was actively conducting a trade or business.

The Court refused to consider the activities of Teragram in 1964 and 1965 which occurred before the distribution of its stock to the petitioners in its determination that Teragram was not actively conducting a trade or business. "We need not reach the more difficult question of whether its activities in 1965 constituted an active trade or business." (Appendix 33–10.)

While Sec. 355(b) requires that the trade or business be actively conducted for a five-year period, it is axiomatic that a business begins in a small way and expands after a period of time. It is clear, however, that the first activities of a business do not rise to the status of "active" only after the second series of activities. Certainly, the first retail store is as actively operated as a chain of 50.

Thus, a determination should have been made based upon all the relevant facts. For this reason, the case should, at the least, be remanded for appropriate findings.

5. There is presently a conflict between the Court of Appeals for the Second Circuit and its decision in *Parshelsky, supra,* and the instant case on the issue of both business purpose and active conduct of a trade or business.

Petitioners believe that it is entirely possible that the Sixth Circuit will decide the *King,* case, *supra,* presently before it, in favor of the petitioners therein. If this occurs there will be a direct conflict between the Court of Appeals for the Sixth Circuit and the Court of Appeals for the First Circuit on the identical issue. In the interests of even-handed tax administration, it is the province of this Court to resolve said conflict.

Conclusion.

For the reasons set forth above, it is respectfully submitted that this petition for a writ of certiorari should be granted, or that this Court delay action on this petition until the Court of Appeals for the Sixth Circuit has reached a decision in the *King* case.

Respectfully submitted.

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Appendix.

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55 T.C. No. 50.

UNITED STATES TAX COURT.

JOSEPH V. RAFFERTY AND
MARGARET M. RAFFERTY, *Petitioners,*
v.
COMMISSIONER OF
INTERNAL REVENUE, *Respondent.*

Docket No. 2536-69. Filed December 14, 1970.

Petitioners own 100 percent of the issued and outstanding stock of corporations A and C. Corporation A owned 100 percent of the stock of corporation B. Between 1960 and 1965 the sole activity of corporation B was the rental of the business situs formerly owned by corporation A to corporation A. In 1965, corporation B acquired land upon which it had constructed a plant that it rented to corporation C as its business situs. *Held,* the distribution of the stock of corporation B by corporation A to petitioners in 1965 constitutes a taxable dividend since corporation B was not engaged in the active conduct of a trade or business for the 5-year period preceding such distribution. Sec. 355(b); sec. 1.355-1(c)(3), Income Tax Regs.

Robert J. McDonough, for the petitioners.
Robert B. Dugan, for the respondent.

DAWSON, *Judge.* Respondent determined a deficiency in petitioners' Federal income tax for the year 1965 in the amount of $93,119.51. The only issue for decision is whether the distribution of 4,430 shares of stock of Teragram Realty Company, Inc., to petitioners by Rafferty

Brown Steel Company, Inc., in 1965 constituted a distribution on which no gain or loss is recognized under the provisions of section 355, Internal Revenue Code of 1954.[1]

Findings of Fact.

Some of the facts have been stipulated by the parties and are found accordingly.

Joseph V. Rafferty and Margaret M. Rafferty (herein called petitioners) are husband and wife who resided in East Longmeadow, Massachusetts, at the time the petition was filed in this case. Petitioners filed their joint Federal income tax return for the year 1965 with the district director of internal revenue, Boston, Massachusetts.

At all times pertinent hereto and to the present, petitioners have jointly owned all of the outstanding shares of stock of Rafferty Brown Steel Co., Inc. (herein called RBS), a Massachusetts corporation engaged in the distribution and processing of cold rolled sheet and strip steel. In May 1960 Teragram Realty Co., Inc. (herein called Teragram) was organized as a Massachusetts corporation and in June 1960, RBS transferred the real property owned by it in East Longmeadow, Massachusetts, where it conducted its steel business, to Teragram in exchange for 4,430 shares of Teragram stock which constituted all of the outstanding stock of Teragram. On June 30, 1960, Teragram then leased back the East Longmeadow realty to RBS for 10 years.

The lease agreement entered into between RBS and Teragram provided, in part, as follows:

> "WITNESSETH, that in consideration of the Covenants herein contained, on the part of the said RAFFERTY-

[1] All statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

BROWN STEEL CO., INC., and its representatives, to be kept and performed by it the said TERAGRAM REALTY CO., INC., doth hereby lease unto the said RAFFERTY-BROWN STEEL CO., INC., the entire real estate holdings of the lessor located on Shaker Road in East Longmeadow, Massachusetts. The said real estate holdings shall include a Shepard-Niles ten (10) ton Overhead Bridge Crane—1957 Model which is agreed to be part of the said realty.

"TO HAVE AND TO HOLD the said premises hereby leased unto the said RAFFERTY-BROWN STEEL CO., INC., and its representatives from the First day of July, 1960 during the full term of ten years thence next ensuing:

"YIELDING AND PAYING (except only in case of fire or other casualties hereinafter mentioned) as rent, the sum of $420,000.00 payable in equal monthly instalments of $35,000.00 with the first instalment to be payable on July 1, 1960, the succeeding instalments to be paid on the first of each succeeding month thereafter for the balance of the term, and for such further time as the said lessee, or any other person or persons claiming under it shall hold the said premises or any part thereof:

"And the said lessee for itself and its representatives hereby covenants and promises with and to the said TERAGRAM REALTY CO., INC., its representatives and assigns, that it will, during the said term, and for such further time as the said Lessee or any other person or persons claiming under it, shall hold the said premises, or any part thereof, pay unto the Lessor or its assigns, the said monthly rent, upon the days hereinbefore appointed for the payment thereof (except only in case of fire or other casualty as hereinafter mentioned), and also all the taxes and assess-

ments whatsoever, whether in the nature of taxes now in being or not, which may be payable for, or in respect of the said premises, or any part thereof during said term, and for such further time as the said Lessee or any person or persons claiming under it shall hold the said premises or any part thereof: AND also will keep all and singular the said premises in such repair as the same are in at the commencement of said term, or may be put in by the said Lessor or its representatives during the continuance thereof; reasonable use and wear, and damage by accidental fire or other inevitable accidents only excepted; and also it will pay the taxes levied for the use of the water furnished by the Town of East Longmeadow during the continuance of this Lease.

"PROVIDED ALWAYS, that in case the premises or any part thereof shall, during said term, be destroyed or damaged by fire or other unavoidable casualty, so that the same shall be thereby rendered unfit for use and habitation, then, and in such case the rent hereinbefore reserved, or a just and proportionate part thereof, according to the nature and extent of the injury sustained, shall be suspended or abated, until the said premises shall have been put in proper condition for use and habitation and in case of such destruction or damage, or a like destruction or damage by any taking or appropriation by public authority for public uses, then the Lessor, its heirs or assigns, may terminate this lease.

"And it is also hereby understood and expressly agreed by the parties to this Indenture, that all merchandise, furniture, and property of any kind, which may be on the premises during the continuance of this lease, is to be at the sole risk and hazard of the Lessee and that if the whole or any part thereof shall be

destroyed or damaged by fire, water or otherwise, or by the use or abuse of the Town water, or by the leakage or bursting of water pipes, or in any other way or manner, no part of said loss or damage is to be charged or to be borne by the Lessor in any case whatever. And the Lessee further promises that it will keep whole and in good condition, all the window and other glass on the premises, and also the pipes, faucets, and water fixtures, and that it will leave the same whole and in good condition at the termination of this lease."

In 1962 Rafferty Brown Steel Co., Inc., of Connecticut (herein called RBS Connecticut) was organized by the petitioners who have jointly owned all of its stock since its formation. RBS Connecticut was organized to acquire the assets of Hawkridge Brothers which operated a general steel products warehouse at Waterbury, Connecticut. After acquiring the assets of Hawkridge Brothers, RBS Connecticut leased for its operations the real property owned by Hawkridge Brothers in Waterbury for a three year period.

In 1965 Teragram acquired a tract of unimproved real property in Waterbury. The approximate cost of the property and the preparation of this land for construction of a plant was $35,000. Teragram contracted for the construction of a plant on such site, arranged mortgage financing using both the Waterbury and East Longmeadow properties as security, and became the sole party obligated on the mortgage. On June 25, 1965, Teragram leased the facility in Waterbury to RBS Connecticut for a term of 14 years.

Teragram has continued to own and lease the realty at Waterbury and East Longmeadow to RBS Connecticut and RBS which companies have continued to operate their businesses at the respective locations through the present

time. These properties are suitable for use by other companies in other types of businesses than those of RBS and RBS Connecticut.

Since its formation in 1960, Teragram's chief executive officer has been Joseph V. Rafferty (herein referred to individually as petitioner) who has been and currently is the company's president and treasurer. Since its formation, Teragram has maintained separate books and records of account and filed separate State and Federal tax returns.

During the years in issue Teragram has derived all of its income from rent paid by RBS or RBS Connecticut. For the taxable years ended March 31, 1961 through March 31, 1965, Teragram received rental income from RBS in the following amounts:

Taxable Year Ended	*Rental Income*
March 31, 1961	$31,500.00*
March 31, 1962	42,000.00
March 31, 1963	42,000.00
March 31, 1964	42,960.00
March 31, 1965	42,960.00

*Nine-month period.

During this same period Teragram claimed recurring annual deductions on its Federal income tax returns for State and local taxes, interest, depreciation, and insurance. No deductions for wages or salaries during this period were claimed on such tax returns.

The earned surplus account of Teragram increased from $4,119.05 as of March 31, 1961, to $46,743.35 as of March 31, 1966, while the earned surplus account of RBS increased from $331,117.97 as of June 30, 1959, to $535,395.77 as of June 30, 1965. In August 1965, RBS distributed the capital stock of Teragram, constituting 4,430 shares, to petitioners.

Other than this stock distribution in 1965, neither RBS nor Teragram has paid any dividends during the years in question.

Prior to the formation of Teragram, petitioner discussed with his accountant his desire to provide for the orderly disposition of RBS. However, he indicated that he wished to exclude his daughters or future sons-in-law from the steel business, while providing them with something that produced a steady income, as opposed to the violently fluctuating income of the steel business. After Teragram was brought into being and during the period between June 1960 and August 1965, petitioner inquired into and discussed with his accountant the possibility of having RBS distribute the Teragram stock. The distribution of this stock was deemed desirable so that gifts of the stock could be made to the daughters of petitioners.

The children of petitioners and the dates of birth of each of them are as follows:

Name	*Date of Birth*
Mary	September 12, 1942
Joseph, Jr.	July 14, 1944
Kevin	April 22, 1946
Martha	October 10, 1947
Anne	May 20, 1951
Michael	November 11, 1952
Thomas	November 10, 1954
Louise	January 13, 1957
John	January 13, 1957

Petitioner was advised by his accountant that the distribution of Teragram stock should not be effected until five years after Teragram was created; that the distribution, in the accountant's opinion, would not be a device for the distribution of earnings and profits; and, in his opinion, the requirements of section 355 of the Internal Revenue

Code regarding the active business provisions had been met. Petitioner has relied solely on his accountant for tax advice from 1948 through 1966 and was counseled by his accountant prior to 1960 that it would be advisable to have a separate real estate corporation formed. Petitioner has never entered into negotiations or taken any other steps to sell the stock of RBS, RBS Connecticut or Teragram.

Ultimate Findings.

1. The primary purpose in forming Teragram and having all of its stock ultimately distributed to petitioners was to facilitate the distribution of assets among the Rafferty children in accordance with the estate plan of petitioner Joseph V. Rafferty.

2. Petitioners have failed to establish that Teragram was engaged in the active conduct of a trade or business throughout the 5-year period preceding the distribution of its stock.

Opinion.

In August 1965 all of the issued and outstanding stock of Teragram was distributed to petitioners by RBS. Petitioner treated this distribution as a nontaxable transaction under section 355.[2] Respondent takes the position that (a)

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[2] SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) EFFECT ON DISTRIBUTEES.—
(1) GENERAL RULE.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—
(i) distributes to a shareholder, with respect to its stock, or
(ii) distributes to a security holder, in exchange for its securities,

the distribution of stock to petitioners was used principally

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device).

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368 (c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

. . . . . .

(b) REQUIREMENTS AS TO ACTIVE BUSINESS.—

(1) IN GENERAL.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

as a device for the distribution of earnings and profits of

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(2) DEFINITION.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

"Present law contemplates that a tax-free separation shall involve only the separation of assets attributable to the carry-on of an active business. Under the House bill, it is immaterial whether the assets are those used in an active business but if investment assets, for example, are separated into a new corporation, any amount received in respect of such an inactive corporation, whether by a distribution from it or by a sale of its stock, would be treated as ordinary income for a period of 10 years from the date of its creation. *Your committee returns to existing law in not permitting the tax free separation of an existing corporation into active and inactive entitles.* It is not believed that the business need for this kind of transaction is sufficiently great to permit a person in a position to afford a 10-year delay in receiving income to do so at capital gain rather than dividend rates. *Your committee requires that both the business retained by the distributing company and the business of the corporation the stock of which is distributed must have been actively conducted for the 5 years preceding the distribution, a safeguard against avoidance not contained in existing law.* [Emphasis added.] [S.. Rept. 1622, 83d Cong., pp. 50-51 (1954).]"

RBS or Teragram or both; (b) Teragram was not engaged in the active conduct of a trade or business immediately after the distribution or for the 5-year period prior to the distribution; and (c) the distribution of Teragram stock to petitioners constitutes a taxable dividend.

In urging that petitioners have failed to meet the "non-device" requirement of section 355(a)(1)(B), respondent argues that petitioners have not justified the incorporation of Teragram and the distribution of Teragram stock to themselves with a valid *corporate* business purpose. Respondent, it would appear, takes a rather myopic view of the transaction in question. The facts unequivocally show that petitioner, through the incorporation of Teragram and the subsequent distribution of its stock by RBS, was seeking to insure the continued existence and success of RBS by precluding any daughters or future sons-in-law from participating in the management of RBS. By making inter vivos or testamentary gifts of the Teragram stock, petitioner believed he would eliminate possible frictions which could arise between his sons, whom he envisioned as his successors in the management of RBS, and his daughters or future sons-in-law who he envisioned as taking only a passive role in the management of RBS, if they should ever acquire an equity interest in that corporation. These reasons, rather than amounting to naked, personal reasons of the petitioners, as respondent contends, are very much intertwined with the most fundamental of business purposes of the corporation, that of continuity of the corporate enterprise and retention of successful and seasoned management personnel and policies. To hold that the implementation of a plan to avoid possible inter-family squabbling or conflict over management of a closely held corporation constitutes a shareholder, non-business related reason seems to be completely at odds with the realities of the situation.

Respondent asserts that the potential for inter-family conflict is as great, if not greater, as a result of the adoption of the plan to make the daughters the holders of only the property at which RBS conducts its business, rather than an interest in RBS itself. We think that as a result of this planned distribution a mutuality of purpose among all members of the family is achieved regarding the continued prosperous operation of RBS. The Rafferty family members active in the management of RBS are free to pursue corporate policies which may include expansion and reinvestment of corporate profits into the steel business while the other family members, who would be inactive in the management of RBS in any event, are provided with a separate corporate entity whose operation they are free to guide either in the direction of further real estate investment or high cash dividend distributions.

Thus, it is our opinion that not only does there exist a valid non-tax reason for the separation of RBS and Teragram but also for the direct ownership of both by petitioners. With respect to whose non-tax reason justifies such a conclusion, it is clear in this case that to distinguish between "corporate purpose" and "shareholder purpose" would be unrealistic and impractical, *Lewis* v. *Commissioner*, 176 F. 2d 646, 650 (C.A. 1, 1949), affirming 10 T.C. 1080 (1948), since the whole transaction was ostensibly devised to insure the continuity of RBS without subjecting it to conflict over its management by the various members of the Rafferty family. However, we hasten to point out that in reaching this conclusion we are by no means adopting the broader rule laid down in *Estate of Parshelsky* v. *Commissioner*, 303 F. 2d 14, 19 (C.A. 2, 1962), where it was stated:

> "Furthermore, since most spin-offs, including the one involved in this case, concern closely-held corporations, it is not only difficult but often purely formal-

> istic to distinguish between corporate and personal benefit. The separate legal entity of corporations cannot obscure the fact that they are operated by their shareholders in the manner most likely to benefit themselves. The benefits to the corporation and to the shareholders are virtually indistinguishable. Consequently, the courts have uniformly held transactions such as reallocations of ownership interests between different groups of shareholders to be tax-free reorganizations. [Citations omitted.]"

To the contrary, we think it is readily apparent that there are certain instances where a distinction between a corporate purpose and a shareholder purpose must be recognized, i.e., where a distribution is affected solely for the purpose of enabling a shareholder to "milk" the parent corporation; where a distribution is effected for the purpose of meeting the personal obligations of the shareholders of the parent corporation; and where a distribution is effected solely for the purpose of reducing accumulated earnings and profits of the parent corporation which have been permitted to accumulate beyond its reasonable needs. These examples, which are illustrative only and are by no means an exhaustive compilation of shareholder reason incompatible with the "business purpose" requirements of section 355, are mentioned merely to underscore the fact that there are situations where a shareholder purpose for a corporate separation will not meet the "business purpose" requirements of the statute. We deem respondent's arguments based on *Gregory* v. *Helvering*, 293 U.S. 465 (1935) inapposite to the factual situation of the instant case and point out that the distribution here in question was indeed effected for cogent reasons related to the operation of RBS.

Respondent next argues that under section 355(b) and section 1.355-1(c), Income Tax Regs., both RBS and Tera-

gram must have been engaged in the active conduct of a trade or business throughout the 5-year period preceding the distribution and immediately following such distribution. Petitioners contend that both RBS and Teragram meet these requirements. They stress that since 1960 Teragram has rented improved multi-purpose real estate, maintained separate financial records and filed its own Federal and State income and excise tax returns. It also, in 1965, arranged for the construction of a building and related facilities at Waterbury, Connecticut, which it financed through a mortgage on which it alone became liable. As a further indication of its engagement in the active conduct of a trade or business, petitioners assert that had RBS ceased to occupy Teragram's rental property, other tenants could have been easily found or the properties could have been easily sold by Teragram.

In attempting to discern precisely what constitutes the active conduct of a trade or business under section 355 and whether Teragram meets these requirements, we find helpful the Senate Finance Committee's report of changes made by it to the Revenue Act of 1954 as originally introduced in the House of Representatives (H.R. 8300, 83d Cong., 2d Sess.). In explaining its revision the Senate Finance Committee stated:

> "Present law contemplates that a tax-free separation shall involve only the separation of assets attributable to the carrying on of an active business. Under the House bill, it is immaterial whether the assets are those used in an active business but if investment assets, for example, are separated into a new corporation, any amount received in respect of such an inactive corporation, whether by a distribution from it or by a sale of its stock, would be treated as ordinary income for a period of 10 years from the date of its creation.

Your committee returns to existing law is not permitting the tax free separation of an existing corporation into active and inactive entities. It is not believed that the business need for this kind of transaction is sufficiently great to permit a person in a position to afford a 10-year delay in receiving income to do so at capital gain rather than dividend rates. *Your committee requires that both the business retained by the distributing company and the business of the corporation the stock of which is distributed must have been actively conducted for the 5 years preceding the distribution, a safeguard against avoidance not contained in existing law.* [Emphasis added.] [S. Rept. 1622, 83 Cong., pp. 50-51 (1954).]"

Hence, the mere division of the corporate entity into two corporations and the subsequent distribution of the stock of one of the corporations after each has been properly aged over five years must be deemed insufficient to meet the requirements of section 355(b). The corporation spun off, in addition to having been seasoned for five years, must have been engaged in the active conduct of a trade or business during such period. See section 1.355-1(c),[3] Income

[3] Sec. 1.355-1 Distribution of stock and securities of controlled corporation.

. . . . . .

(c) Active business. Section 355 is not applicable unless the controlled corporation and the distributing corporation are each engaged in the active conduct of a trade or business. For specific rules in this connection see section 355 (b) (1) and (2). Without regard to such rules, for purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such

Tax Regs., elaborating on this point; see also, Massee "Section 355: Disposal of Unwanted Assets in Connection with a Reorganization," 22 Tax L. Rev. 439, 459.

In the instant case, between 1960 and approximately January 1965, Teragram's sole activity was the leasing of the East Longmeadow property to RBS, its parent company. Under the terms of the lease between RBS and Teragram, RBS was responsible for all maintenance and repair work required by the property. Teragram held title to the property and paid various taxes and insurance premiums due with respect to the property. Petitioners, upon whom the burden of proof rests in this case, have shown no further activities on the part of Teragram during such period. Respondent points out, on the other hand, that for this same period Teragram's sole source of income was rent paid by RBS, its parent company; that Teragram apparently had no employees during this period; and that Teragram did not claim any deductions for compensation paid to its president and treasurer, Joseph V. Rafferty, for any services rendered during such period. In view of these facts we conclude that Teragram was not engaged in the active conduct of a trade or business for the 5-year period preceding the distribution of its stock to petition-

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group of activities ordinarily must include the collection of income and the payment of expenses. It does not include—

(1) The holding for investment purposes of stock, securities, land or other property, including casual sales thereof (whether or not the proceeds of such sales are reinvested).

(2) The ownership and operation of land or buildings all or substantially all of which are used and occupied by the owner in the operation of a trade or business, or

(3) A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.

ers.[4] See *Henry H. Bonsall, Jr.*, 317 F. 2d 61 (C.A. 2, 1963), affirming a Memorandum Opinion of this Court; *Theodore F. Appleby*, 35 T.C. 755 (1961), affirmed per curiam 296 F. 2d 925 (C.A. 3, 1962), certiorari denied 370 U.S. 910 (1962); and *Isabel A. Elliott*, 32 T.C. 283 (1959).

Our conclusion is not altered by virtue of Teragram's increased business activities which began around January 1965 when it acquired property in Waterbury, Connecticut, and contracted for the erection of a plant which it leased to RBS Connecticut, another steel company 100 percent owned by petitioners. While the fact that Teragram obtained the financing for this project through a mortgage on which it alone became liable is an indication of some independent business activity on the part of Teragram, it is by no means conclusive. Moreover, this increased business activity did not commence until the very year of the distribution of the Teragram stock to petitioners. To hold, on the basis of this increased activity in 1965, if such activity does in fact constitute the conduct of an active trade or business, that Teragram has been so engaged since 1960 would simply result in the defenestration of the requirements of section 355(b).

In their attempt to illustrate the separate active business of Teragram petitioners suggest that because of the

[4] See and compare sec. 346(b)(1), requiring the active conduct of a trade or business for the 5-year period preceding a distribution; sec. 1372(e)(5) defining "passive investment income" as gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom); and sec. 822(b) defining "gross investment income" as the gross amount of income during the taxable year from (A) interest, dividends, rents, and royalties, (B) the entering into of any lease mortgage, or other instrument or agreement from which the insurance company derives interest, rents, or royalties.

multi-purpose nature of Teragram's properties they could be easily rented or *sold* if RBS or RBS Connecticut decided to abandon them for some reason. It is just such a possibility of sale that has caught the awareness of the courts. In the *Bonsall* case, *supra*, at p. 65, the Court of Appeals for the Second Circuit said:

> "It is clear that careful scrutiny of purported real-estate rental businesses is necessary to prevent evasion of the purposes of the statute. The possibility of the shareholders abstracting accumulated earnings at capital gains rates is present whenever a corporation owns its own factory or office building. Under taxpayers' interpretation, all that need be done is to transfer the building to a new corporation and distribute the stock received in return. The shareholders would then be free to sell their stock and pay a capital gains rate on the proceeds while the corporation can rent or purchase another building and reduce its accumulated earnings. The present case is little more than that, and it is noteworthy that the two prior cases decided under this section other than *Coady, Theodore F. Appleby, supra*, and *Isabel A. Elliott, supra*, were likewise factually similar. Only long application may completely clarify the difficult terminology of section 355. But obvious cases such as presented here plainly must be excluded from tax-free treatment."

Here, after an easily arranged sale of Teragram's properties, petitioners would be free to liquidate Teragram or arrange a straight sale of their Teragram stock. The fact that this has not occurred is just as inconclusive as though a sale had taken place prior to trial. What is of crucial importance is that, regardless of the valid business pur-

pose for such a transaction,[5] petitioners have extracted through an attempted tax free spin-off what are in substance passive, investment type assets. This transaction is a "bailout" of the earnings and profits of RBS and Teragram and to this extent constitutes a "device" for the distribution of such earnings and profits. Petitioners have failed to prove otherwise.

We are mindful of the fact that to some extent every corporate separation is a device for the distribution of earnings and profits insofar as there is direct ownership by the stockholders of something they did not previously hold directly.[6] However, what we must decide in this case

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[5] See Whitman, "Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code." Harv. L. Rev. 1194, 1243-1244, where this point is emphasized in a critique of the *Parshelsky* case:

> "In Estate of *Moses L. Parshelsky*, 236, the Service leaned heavily on the corporate/shareholder distinction in the business purpose doctrine. As might have been predicted from the repudiation in *Lewis* v. *Commissioner*, 237 this was at best a weak link in the enforcement chain, and the Second Circuit discarded it. But again emphasis upon business purposes obscured the real issue. Here, the seventy-two-year-old sole shareholder of a business with large accumulated earnings spun off real estate assets worth more than 350,000 dollars to himself, ostensibly to facilitate his estate planning. It was this 'shareholder purpose' that finally legitimatized the separation. 238 But the whole transacttion seems to have been a bailout, artfully contrived, perhaps, but a bailout nonetheless. Had Parshelsky tried to obtain the earnings himself without paying a dividend tax, he would probably have failed to qualify for a valid spin-off the device concept under the 1951 act was weak, but it did cover glaring post-distribution sales. 239 • • • Why then should the fact that he wanted to plot out his estate legitimatize a spin-off that would otherwise fail? Intent of the shareholder is relevant, but the statutory test speaks in terms of result, and the effect here has been a bailout. [Footnotes omitted.]"

[6] See Mintz, "Corporate Separations," 36 Taxes 882, 887 (1958).

is whether the transaction in question fits within the requirements of the statute and the expressed legislative purpose of providing "for non-recognition of gain or loss in cases which involve a mere rearrangement of the corporate structure or other shifts in the form of corporate enterprise which do not involve any distributions of corporate assets to shareholders." H.R. Rept. No. 1337, 83d Cong., 2d Sess., p. 34 (1954); accord, S. Rept. No. 1662, 83d Cong., 2d Sess., p. 43 (1954). For the reasons stated herein, we conclude that there has not been a mere rearrangement in the form of the corporate enterprise and a functional division of two corporations engaged in the active conduct of separate trades or businesses for the 5-year period preceding the distribution of the Teragram stock to petitioners. Accordingly, we hold that the distribution of Teragram stock to petitioners in August 1965 does not satisfy the requirements of section 355.

Decision will be entered for the respondent.

UNITED STATES COURT OF APPEALS
for the First Circuit.

No. 71-1121.

Judgment.

[Entered December 6, 1971.]

This cause came on to be heard on appeal from the Tax Court of the United States and was argued by counsel.

Upon consideration whereof, it is now here ordered, adjudged and decreed as follows: The decision of the Tax Court is affirmed.

By the Court,
DANA H. GALLUP, Clerk.

United States Court of Appeals
For the First Circuit

No. 71-1121

JOSEPH V. RAFFERTY, ET AL.,

PETITIONERS, APPELLANTS,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT, APPELLEE.

APPEAL FROM THE TAX COURT OF THE UNITED STATES

Before ALDRICH, *Chief Judge*,
McENTEE and COFFIN, *Circuit Judges*.

Robert J. McDonough, with whom *Daniel S. Fischbach* and *Herrick, Smith, Donald, Farley & Ketchum* were on brief, for appellants.

David English Carmack, Attorney, Tax Division, Department of Justice, with whom *Johnnie M. Walters*, Assistant Attorney General, *Myer Rothwacks*, and *Elmer J. Kelsey*, Attorneys, Tax Division, Department of Justice, were on brief, for appellee.

December 6, 1971

McENTEE, *Circuit Judge*. Taxpayers, Joseph V. Rafferty and wife, appeal from a decision of the Tax Court which held that a distribution to them of all the outstanding stock of a real estate holding corporation did not meet the requirements of § 355 of the Internal Revenue Code of 1954 and therefore was taxable as a dividend. Our opinion requires a construction of § 355 and the regulations thereunder.[1]

[1] The relevant parts of § 355 Int. Rev. Code of 1954 are as follows:
"§ 355. *Distribution of stock and securities of a controlled corporation*
(a) *Effect on distributees.*—
(1) *General rule.*—*If*—

. . . .

(B) the transaction was not used *principally as a device* for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both . . . [and]

The facts, some of which have been stipulated, are relatively simple. The taxpayers own all the outstanding shares of Rafferty Brown Steel Co., Inc. (hereinafter RBS), a Massachusetts corporation engaged in the processing and distribution of cold rolled sheet and strip steel in Longmeadow, Massachusetts. In May 1960, at the suggestion of his accountant, Rafferty organized Teragram Realty Co., Inc., also a Massachusetts corporation. In June of that year RBS transferred its Longmeadow real estate to Teragram in exchange for all of the latter's outstanding stock. Thereupon Teragram leased back this real estate to RBS for ten years at an annual rent of $42,000. In 1962 the taxpayers also organized Rafferty Brown Steel Co., Inc., of Connecticut (RBS Conn.), which corporation acquired the assets of Hawkridge Brothers, a general steel products warehouse in Waterbury, Connecticut. Since its inception the taxpayers have owned all of the outstanding stock in RBS Conn. From 1962 to 1965 Hawkridge leased its real estate in Waterbury to RBS Conn. In 1965 Teragram purchased some unimproved real estate in Waterbury and built a plant there.[2]

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, . . .

. . . .

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(b) *Requirements as to active business.*—

(1) *In general.*—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation . . . is engaged immediately after the distribution in the active conduct of a trade or business, or

. . . .

(2) *Definition.*—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, . . .

(B) *such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,*

. . . ." (Emphasis added.)

[2] Teragram contracted for the construction of the plant, arranged mortgage financing by using the Longmeadow and Waterbury properties as security, and became solely obligated on the mortgage.

In the same year it leased this plant to RBS Conn. for a term of fourteen years. Teragram has continued to own and lease the Waterbury real estate to RBS Conn. and the Longmeadow realty to RBS, which companies have continued up to the present time to operate their businesses at these locations.[3]

During the period from 1960 through 1965 Teragram derived all of its income from rent paid by RBS and RBS Conn. Its earned surplus increased from $4,119.05 as of March 31, 1961, to $46,743.35 as of March 31, 1965. The earned surplus of RBS increased from $331,117.97 as of June 30, 1959, to $535,395.77 as of June 30, 1965. In August 1965, RBS distributed its Teragram stock to the taxpayers. Other than this distribution, neither RBS nor Teragram has paid any dividends.

Joseph V. Rafferty has been the guiding force behind all three corporations, RBS, RBS Conn., and Teragram. He is the president and treasurer of Teragram which, while it has no office or employees, keeps separate books and records and filed separate tax returns for the years in question.[4]

On various occasions Rafferty consulted his accountant about estate planning, particularly about the orderly dis-

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[3] Both properties are also suitable for use by other companies in other types of business.

[4] The tax returns for Teragram for the five fiscal years 1961 through 1965 reveal the following deductions:

Compensation of officers	none
Salaries and wages	none
Rent	none
Travel (all in 1965)	$16.52
Office expenses (all in 1965)	9.25

The total deductions taken by Teragram over the five year period were $171,135.94. The bulk of that amount was as follows:

Taxes	$ 43,980.59
Interest	36,985.57
Depreciation	74,213.21
Insurance	5,565.26
Legal, auditing, and organizational expenses	1,274.25
Repairs (all in 1965)	8,500.00
Fire Loss (all in 1962)	591.29
	$171,110.17

position of RBS.[5] While he anticipated that his sons would join him at RBS, he wanted to exclude his daughters (and/or his future sons-in-law) from the active management of the steel business. He wished, however, to provide them with property which would produce a steady income. The accountant recommended the formation of Teragram, the distribution of its stock, and the eventual use of this stock as future gifts to the Rafferty daughters. The taxpayers acted on this advice and also on the accountant's opinion that the distribution of Teragram stock would meet the requirements of § 355.

In their 1965 return the taxpayers treated the distribution of Teragram stock as a nontaxable transaction under § 355. The Commissioner viewed it, however, as a taxable dividend and assessed a deficiency. He claimed (a) that the distribution was used primarily as a device for the distribution of the earnings and profits of RBS or Teragram or both, and (b) that Teragram did not meet the active business requirements of § 355.

We turn first, to the Tax Court's finding that there was no device because there was an adequate business purpose for the separation and distribution of Teragram stock. In examining this finding we are guided by the rule that the taxpayer has the burden of proving that the transaction was not used principally as a device. *Wilson* v. *Commissioner*, 42 T.C. 914, 922 (1964), *rev'd on other grounds*, 353 F. 2d 184 (9th Cir. 1965). Initially, we are disturbed by the somewhat uncritical nature of the Tax Court's finding of a business purpose. Viewing the transaction from the standpoint of RBS, RBS Conn., or Teragram, no immediate business reason existed for the distribution of Teragram's stock to the taxpayers. Over the years the businesses had been profitable, as witnessed by the substantial increase of the

[5] Rafferty's concern is understandable in view of the fact that he had nine children.

earned surplus of every component, yet none had paid dividends. The primary purpose for the distribution found by the Tax Court was to facilitate Rafferty's desire to make bequests to his children in accordance with an estate plan.[6] This was a personal motive. Taxpayers seek to put it in terms relevant to the corporation by speaking of avoidance of possible interference with the operation of the steel business by future sons-in-law, pointing to *Coady* v. *Commissioner*, 33 T.C. 771 (1960), *aff'd per curiam*, 289 F. 2d 490 (6th Cir. 1961).

In *Coady*, however, the separation was in response to a seemingly irreconcilable falling-out between the owners of a business. This falling-out had already occurred and, manifestly, the separation was designed to save the business from a substantial, present problem. *See also Olson* v. *Commissioner*, 48 T.C. 855, 867 *modified*, 49 T.C. 84 (1967). In the case at bar there was, at best, only an envisaged possibility of future debilitating nepotism. If avoidance of this danger could be thought a viable business purpose at all, it was so remote and so completely under the taxpayers' control that if, in other respects the transaction was a "device," that purpose could not satisfy the taxpayers' burden of proving that it was not being used "principally as a device" within the meaning of the statute.

Our question, therefore, must be whether taxpayers' desire to put their stockholdings into such form as would facilitate their estate planning, viewed in the circumstances of the case, was a sufficient personal business purpose to prevent the transaction at bar from being a device for the distribution of earnings and profits. While we remain of the view, which we first expressed in *Lewis* v. *Commissioner*,

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[6] This plan incorporated two objectives: (1) the exclusion of daughters and sons-in-law from active management of the steel business and (2) providing his daughters with investment assets, safe and independent from the fluctuations of the steel business.

176 F. 2d 646 (1st Cir. 1949), that a purpose of a shareholder, qua shareholder, may in some cases save a transaction from condemnation as a device, we do not agree with the putative suggestion in *Estate of Parshelsky* v. *Commissioner*, 303 F. 2d 14, 19 (2d Cir. 1962), that any investment purpose of the shareholders is sufficient. Indeed, in *Lewis*, although we deprecated the distinction between shareholder and corporate purpose, we were careful to limit that observation to the facts of that case, and to caution that the business purpose formula "must not become a substitute for independent analysis." 176 F. 2d at 650. For that reason we based our decision on the Tax Court's finding that the transaction was "undertaken for reasons germane to the continuance of the corporate business." *Id.* at 647.

This is not to say that a taxpayer's personal motives cannot be considered, but only that a distribution which has considerable potential for use as a device for distributing earnings and profits should not qualify for tax-free treatment on the basis of personal motives unless those motives are germane to the continuance of the corporate business. *Cf. Commissioner* v. *Wilson*, 353 F. 2d 184 (9th Cir., 1965); Treas. Reg. § 1.355-2(c). We prefer this approach over reliance upon formulations such as "business purpose," and "active business." *See generally* Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 Harv. L. Rev. 1194 (1968). The facts of the instant case illustrate the reason for considering substance. Dividends are normally taxable to shareholders upon receipt. Had the taxpayers received cash dividends and made investments to provide for their female descendants, an income tax would, of course, have resulted. Accordingly, once the stock was distributed, if it could potentially be converted into cash without thereby impairing taxpayers' equity interest in RBS, the transaction could

easily be used to avoid taxes. The business purpose here alleged, which could be fully satisfied by a bail-out of dividends, is not sufficient to prove that the transaction was not being principally so used.

Given such a purpose, the only question remaining is whether the substance of the transaction is such as to leave the taxpayer in a position to distribute the earnings and profits of the corporation away from, or out of the business. The first factor to be considered is how easily the taxpayer would be able, were he so to choose, to liquidate or sell the spun-off corporation. Even if both corporations are actively engaged in their respective trades, if one of them is a business based principally on highly liquid investment-type, passive assets, the potential for a bail-out is real. The question here is whether the property transferred to the newly organized corporation had a readily realizable value, so that the distributee-shareholders could, if they ever wished, "obtain such cash or property or the cash equivalent thereof, either by selling the distributed stock or liquidating the corporation, thereby converting what would otherwise be dividends taxable as ordinary income into capital gain . . . ." *Wilson* v. *Commissioner*, *supra*, 42 T.C. at 923. In this connection we note that the Tax Court found that a sale of Teragram's real estate properties could be "easily arranged." 55 T.C. at 353. Indeed, taxpayers themselves stressed the fact that the buildings were capable of multiple use.

There must, however, be a further question. If the taxpayers could not effect a bail-out without thereby impairing their control over the on-going business, the fact that a bail-out is theoretically possible should not be enough to demonstrate a device because the likelihood of it ever being so used is slight. "[A] bail-out ordinarily means that earnings and profits have been drawn off without impairing the

shareholder's residual equity interest in the corporation's earning power, growth potential, or voting control." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* (3d ed. 1971) § 13.06. If sale would adversely affect the shareholders of the on-going company, the assets cannot be said to be sufficiently separated from the corporate solution and the gain sufficiently crystallized as to be taxable. *See Lewis* v. *Commissioner*, *supra* at 650. In this case, there was no evidence that the land and buildings at which RBS carried on its steel operations were so distinctive that the sale of Teragram stock would impair the continued operation of RBS, or that the sale of those buildings would in any other way impair Rafferty's control and other equity interests in RBS.[7]

In the absence of any direct benefit to the business of the original company, and on a showing that the spin-off put saleable assets in the hands of the taxpayers, the continued retention of which was not needed to continue the business enterprise, or to accomplish taxpayers' purposes, we find no sufficient factor to overcome the Commissioner's determination that the distribution was principally a device to distribute earnings and profits.

The taxpayers fail for a further reason. The Tax Court found that Teragram was not an active business within the meaning of § 355(b).[8] The Commissioner contends that this result is mandated by Treas. Reg. § 1.355-1(c)[9] and the

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[7] Our conclusion is reinforced by the fact that RBS and RBS Conn. were guaranteed occupancy of Teragram property under long term leases at fixed rents.

[8] *See* note 1 *supra*.

[9] Treas. Reg. § 1.355-1(c) (1955):

"(c) *Active business.* Section 355 is not applicable unless the controlled corporation and the distributing corporation are each engaged in the active conduct of a trade or business. For specific rules in this connection see section 355(b) (1) and (2). *Without regard to such rules*, for purposes of section 355, a trade or business . . . . ordinarily must include the collection of income and the payment of expenses. *It does not include*—

examples in Treas. Reg. § 1.355-1(d). The correctness of these regulations is questionable in view of the rejection of the separate business requirement of § 1.355-1(a) in *United States* v. *Marett*, 325 F. 2d 28 (5th Cir. 1963) and *Coady* v. *Commissioner*, *supra*.[10] In fact, Revenue Ruling 64-147, 1964-1 Cum. Bull. pt. 1, at 136, indicates that the Commissioner recognized a need to modify the § 355 regulations.[11] Moreover, we find that the regulations in this area are so broadly drawn that they may in some instances defeat the congressional purpose behind the enactment of § 355,[12] and

(1) The holding for investment purposes of stock, securities, land or other property, including casual sales thereof (whether or not the proceeds of such sales are reinvested).

"The ownership and operation of land or buildings all or substantially all of which are used and occupied by the owner in the operation of a trade or business, or

"A group of activities which, while a part of a business operated for profit, *are not themselves independently producing income* even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial." (Emphasis added.)

[10] Treas. Reg. § 1.355-1(a) (1955) states: "Section 355 does not apply to the division of a single business." The Commissioner has since acquiesced in the decisions holding this regulation invalid. *See* note 11 *infra*. At argument the Commissioner contended for a broad reading of the phrase in Treas. Reg. § 1.355-1(c) (3) which excludes from the active business definition those activities not themselves independently producing income. We find that these regulations are largely a restatement of the rejected separate business requirement of § 1.355-1(a), and we believe the *Coady* rationale is also applicable to functional divisions of existing businesses. *See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders*, *supra* at ¶ 13.04. We therefore reject the Commissioner's broad contention.

[11] "The Internal Revenue Service will follow the decisions of the United States Court of Appeals for the Fifth Circuit in the case of *United States* v. *W. W. Marett, et al.*, 325 Fed. (2d) 28 (1963), and of the United States Court of Appeals for the Sixth Circuit in the case of *Commissioner* v. *Edmund P. Coady, et ux.*, 289 Fed. (2d) 490 (1961), to the extent they hold that section 1.355-1(a) of the Income Tax Regulations, providing that section 355 of the Internal Revenue Code of 1954 does not apply to the division of a single business, is invalid.

. . . .

"*Consideration is being given to a modification of the regulations.*" (Emphasis added.)

[12] For example, the regulations could be construed to deny § 355 treatment for a large hotel chain which spun-off its land purchasing, hotel construction, and leasing activities from its hotel management operations if the spun-off corporation leased the completed hotels exclusively to the management corporation. We are reluctant to approve such regulations which appear to fly in the face of Congressional intent.

we decline to rest our decision on so tenuous a foundation.

It is our view that in order to be an active trade or business under § 355 a corporation must engage in entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments. Moreover, there should be objective indicia of such corporate operations. Prior to 1965 Teragram's sole venture was the leasing back to its parent of its only asset for a fixed return, an activity, in economic terms, almost indistinguishable from an investment in securities. Standing by itself this activity is the type of "passive investment" which Congress intended to exclude from § 355 treatment.[13] Furthermore, there are hardly any indicia of corporate operations. Prior to 1965 Teragram paid neither salaries nor rent. It did not employ independent contractors, and its only activity appears to have been collecting rent, paying taxes, and keeping separate books. Prior to 1965 it failed to meet either set of criteria for an active trade or business. We need not reach the more difficult question of whether its activities in 1965 constituted an active trade or business.

Affirmed.

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[13] Existing law reflects the Senate modification of the House proposal for § 355. In the accompanying report the Senate Finance Committee stated:

"Under the House bill, it is immaterial whether the assets are those used in an active business . . . . Your committee returns to existing law in not permitting the tax free separation of an existing corporation *into active and inactive entities*. It is not believed that the business need for this kind of transaction is sufficiently great to permit a person in a position to afford a 10-year delay in receiving income to do so at capital gain rather than dividend rates. Your committee requires that both the business retained by the distributing company and the business of the corporation the stock of which is distributed must have been actively conducted for the 5 years preceding the distribution, a safeguard against avoidance not contained in existing law." S. Rep. No. 1622, 83d Cong., 2d Sess. 50-51 (1954) (emphasis added).

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Statutes and Regulations Involved.

I.R.C. 1954.

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) EFFECT ON DISTRIBUTEES.—

(1) GENERAL RULE.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution.

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (B) (relating to active businesses) are satisfied, and

(D) as part of the distribution the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368 (c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(b) REQUIREMENTS AS TO ACTIVE BUSINESS.—

(1) IN GENERAL.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) DEFINITION.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period. (68A Stat. 113).

I.R.C. 1939.

SEC. 112(b)

(11) DISTRIBUTION OF STOCK NOT IN LIQUIDATION.—

If there is distributed, in pursuance of a plan of reorganization, to a shareholder of a corporation which is a party to the reorganization, stock (other than preferred stock) in another corporation which is a party to the reorganization, without the surrender by such shareholder of stock, no gain to the distributee from the receipt of such stock shall be recognized unless it appears that (A) any corporation which is a party to such reorganization was not intended to continue the active conduct of a trade or business after such reorganization, or (B) the corporation whose stock is distributed was used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization. (65 Stat. 493).

REG. SEC. 1.355-1. DISTRIBUTION OF STOCK AND SECURITIES OF CONTROLLED CORPORATION.—

(a) Application of Section. Section 355 provides for the separation, without recognition of gain or loss to the shareholders and security holders, of two or more existing businesses formerly operated, directly or indirectly, by a single corporation. It applies only to the separation of existing businesses which have been in active operation for at least five years and which, in general, have been owned for at least five years by the corporation making the distribution of stock or of stock and securities. Section 355 does not apply to the division of a single business. For the purpose of section 355, stock rights or stock warrants are not included in the term "stock and securities."

(b) Types of separations. Section 355 is concerned with two general types of separations of businesses. The first is the distribution of the stock of an existing corporation. The second is the distribution of the stock of a new corporation which stock was received in exchange for the assets of a business previously operated by the distributing corporation. In both cases, this section contemplates the continued operation of the businesses existing prior to the separation.

(c) Active Business. Section 355 is not applicable unless the controlled corporation and the distributing corporation are each engaged in the active conduct of a trade or business. For specific rules in this connection see section 355(b)(1) and (2). Without regard to such rules, for purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses.

It does not include—

(1) The holding for investment purposes of stock, securities, land or other property, including casual sales thereof (whether or not the proceeds of such sales are reinvested),

(2) The ownership and operation of land or buildings all or substantially all of which are used and occupied by the owner in the operation of a trade or business, or

(3) A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with larger increases in activities previously incidental or insubstantial.

(d) The following examples illustrate the application of the rules described in paragraph (c) of this section:

Example (1). Corporation A is engaged in the manufacture and sale of soap and detergents and owns investment securities. It proposes to place the investment securities in a new corporation and distribute the stock of such new corporation to its shareholders. The holding of investment securities does not constitute a trade or business.

Example (2). Corporation B is engaged in the business of manufacturing and selling hats in its own factory building. It proposes to transfer the factory building to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in connection with the manufacturing of hats constitute a trade or business; but the operation of the factory building does not.

Example (3). Corporation C, a bank, owns an eleven-story downtown office building, the ground floor of which is occupied by it in the conduct of its banking business and the remaining ten floors of which it rents to various tenants. The ten floors are rented, managed and main-

tained by the real estate department of the bank. It is proposed to transfer the building to a new corporation and distribute the stock of such new corporation to the bank's shareholders. The activities in connection with banking constitute a trade or business as do also the activities in connection with the rental of the building.

Example (4). Corporation D, a bank, owns a two-story building in a surburban area, the ground floor and approximately one-half of the second floor of which is occupied by it in the conduct of its banking business. The remainder of the second floor is rented as storage space to a neighboring retail merchant. It is proposed to transfer the building to a new corporation and distribute the stock of such new corporation to the bank's shareholders. With respect to the rental of part of the second floor of its building, the bank is not engaged in the active conduct of a trade or business, such activity being only incidental to its banking business.

Example (5). Corporation E is engaged in the manufacture and sale of wood products. In connection with such manufacturing, it maintains a research department for its own use. It proposes to transfer the research department to a new corporation after which it will engage the services of the new corporation on a contract basis. The activities of the research department do not constitute a trade or business.

Example (6). Corporation F owns and rents an office building and owns vacant land. It proposes to transfer the vacant land to a new corporation and distribute the stock of such new corporation to its shareholders. The holding of the vacant land does not constitute a trade or business.

Example (7). Corporation G owns land on which it engages in the ranching business. Oil has been discovered in the area and it is apparent that oil may be found under the

land on which the ranching activities are maintained. Corporation G has engaged in no activities in connection with the mineral rights. It proposes to transfer the mineral rights to a new corporation and distribute the stock of such new corporation to shareholders. Corporation G is not engaged in an active trade or business with respect to the mineral rights.

Example (8). Corporation H manufactures and sells ice cream at a plant in State X and at a plant in State Y. Corporation H proposes to transfer the plant and related activities in State Y to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each State constitute a trade or business.

Example (9). Corporation I manufactures and sells ice cream in State X. It purchases land and constructs a new plant in State Y. After manufacturing and selling operations have commenced at the new plant, it proposes to transfer it to a new corporation and distribute the stock of such new corporation to its shareholders. The activities at the new plant constitute a trade or business which, however, has been in existence only since such activities began.

Example (10). Corporation J has owned and operated a men's retail clothing store in the downtown area of the City of R for seven years and has also owned and operated a men's retail clothing store in the suburban area of the City of R for nine years. The manager of each store directs its operations and makes the necessary purchases. No common warehouse is maintained. Corporation J proposes to transfer the store building, fixtures, and inventory of the suburban store to a new corporation and distribute the stock of such new corporation to the shareholders of Corporation J. The activities of each store constitute a trade or business which has been in existence for more than five years.

Example (11). Corporation K processes and sells meat products. It is proposed to separate the selling from the manufacturing activities by forming a separate corporation, L, to handle sales. Corporation K will transfer to Corporation L certain physical assets pertaining to the sales function plus cash for working capital in exchange for the capital stock of Corporation L which will be distributed to the shareholders of Corporation K. Since the manufacturing and selling operations constitute only one integrated business, neither Corporation K nor Corporation L will be continuing the active conduct of a trade or business formerly conducted by Corporation K.

Example (12). Corporation M is engaged in the manufacture and sale of steel and steel products. In addition, Corporation M owns and operates a coal mine for the sole purpose of supplying its coal requirements in the manufacture of steel. It is proposed to transfer the coal mine to a new corporation and distribute the stock of such new corporation to the shareholders of Corporation M. The activities of Corporation M in connection with the operation of the coal mine do not constitute a trade or business, since such activities are not themselves independently producing income although a part of the business operated for profit.

Example (13). Corporation N manufactures steel containers for oil and oil products at a plant in State X and at a plant in State Y. Pursuant to a sales contract with Corporation O, Corporation N sells its entire product to Corporation O. Corporation N proposes to transfer the plant and related activities in State Y, together with that portion of the sales contract with Corporation O applicable to the sales of that plant to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each state constitute a trade or

business before and after the transfer to the new corporation.

Example (14). Corporation P manufactures and sells steel containers for oil and oil products at a plant in State X and at a plant in State Y. Corporation P makes all of its sales through its wholly-owned subsidiary pursuant to a sales contract, by virtue of which the subsidiary acts either as principal or sales agent for Corporation P. Corporation P proposes to transfer the plant and related activities in State Y together with that portion of the sales contract applicable to the sales of that plant to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each State constitute a trade or business before and after the transfer to the new corporation.

Example (15). Corporation Q manufactures electrical products at a plant in State X and at a plant in State Y. The sales of the electrical products produced by each plant are made by the corporation's sales office located at the plant in State X. Corporation Q proposes to transfer the plant and related activities in State Y together with that portion of the facilities and personnel of the sales office allocable to the sales of the plant in State Y to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each state constitute a trade or business before and after the transfer to the new corporation.

Example (16). Corporation R manufactures and sells automobiles and operates an executive dining room primarily for the convenience of its executives. The dining room is managed and operated as a separate unit and the executives are charged for their meals. Corporation R derives a profit from the operation of the dining room. The activities connected with the executive dining room do not constitute a trade or business.

(e) Businesses operated by one corporation. For further examples of businesses operated by one corporation, see paragraph (d) of § 1.337-3.

REG. SEC. 1.355-2. LIMITATIONS.

(a) Property distributed.

The property distributed must consist solely of stock or stock and securities of a controlled corporation. If additional property (including an excess principal amount of securities received over securities surrendered) is received, see section 356.

(b) Distribution of earnings and profits.

(1) The transaction must not have been used principally as a device for the distribution of the earnings and profits of the distributing corporation or of the controlled corporation or of both. If, pursuant to an arrangement negotiated or agreed upon prior to the distribution of stock or securities of the controlled corporation, part or all of the stock or securities of either corporation are sold or exchanged after the distribution, such sale or exchange will be evidence that the transaction was used principally as a device for the distribution of the earnings and profits of the distributing corporation or of the controlled corporation, or both. However, if the rules respecting continuity of interest contained in paragraph (c) of this section are not met, section 355 will not apply. If a sale of such stock or securities is made after the distribution and is not pursuant to an arrangement negotiated or agreed upon prior to the distribution, the mere fact of such sale is not determinative that the transaction was used principally as a device for the distribution of earnings and profits, but such fact will be evidence that the transaction was used principally as such a device.

(2) A sale is pursuant to an arrangement agreed upon prior to the distribution when enforcible rights to buy or

sell exist before such distribution. In any case in which a sale or exchange was discussed by the buyer and the seller before the distribution, but enforcible rights to buy or to sell did not exist before such distribution, the question whether an arrangement was negotiated within the meaning of section 355(a)(1)(B) shall be determined from all the facts and circumstances.

(3) In determining whether a transaction was used principally as a device for the distribution of the earnings and profits of the distributing corporation or of the controlled corporation or both, consideration will be given to all of the facts and circumstances of the transaction. In particular, consideration will be given to the nature, kind and amount of the assets of both corporations (and corporations controlled by them) immediately after the transaction. The fact that at the time of the transaction substantially all of the assets of each of the corporations involved are and have been used in the active conduct of trades or businesses which meet the requirements of section 355(b) will be considered evidence that the transaction was not used principally as such a device.

(c) Business purpose. The distribution by a corporation of stock of securities of a controlled corporation to its shareholders with its own stock or to its security holders in exchange for its own securities will not qualify under section 355 where carried out for purposes not germane to the business of the corporations. The principal reason for this requirement is to limit the application of section 355 to certain specified distributions or exchanges with respect to the stock or securities of controlled corporations incident to such readjustment of corporate structures as is required by business exigencies and which, in general, effect only a readjustment of continuing interests in property under modified corporate forms. Section 355 contemplates a continuity of the entire business enterprise under modified

corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange. All the requisites of business and corporate purposes described under § 1.368 must be met to exempt a transaction from the recognition of gain or loss under this section.

(d) Stock and securities distributed. The distributing corporation must distribute:

(1) All of the stock and securities of the controlled corporation which it owns, or

(2) At least an amount of the stock which constitutes control as defined in section 368(c). In such case all, or any part, of the securities of the controlled corporation may be distributed.

Where a part of either the stock or securities is retained under subparagraph (2) of this paragraph, it must be established to the satisfaction of the Commissioner that such retention was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Ordinarily, the business reasons (as distinguished from the desire to make a distribution of the earnings and profits) which support a distribution of stock and securities of a controlled corporation under paragraph (c) of this section will require the distribution of all of the stock and securities. If the distribution of all of the stock and securities of a controlled corporation would be treated to any extent as a distribution of "other property" under section 356, this fact does not tend to establish that the retention of any of such stock and securities is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

(e) Principal amount of securities.

(1) Section 355(a)(1) is not applicable if the principal amount of securities received exceeds the principal amount

of securities surrendered or if securities are received and no securities are surrendered. In such cases, see section 356.

(2) If only stock is received in a transaction to which section 355 is applicable, the principal amount of securities surrendered, if any, and the par or stated value of stock is not relevant to the application of such section. For example: All of the stock of Corporation A is owned by X, an individual, and securities in the principal amount of $100,000 which were issued by Corporation A are owned by Y, an individual. Corporation A distributes all of the stock of a controlled corporation to Y in exchange for his securities. The par or stated value of the stock of the controlled corporation is $150,000. No gain or loss is recognized to Y upon the receipt of the stock of the controlled corporation.

(f) Period of ownership.

(1) For the purposes of determining whether gain or loss will be recognized upon a distribution, stock of a controlled corporation acquired (in a transaction in which gain or loss is recognized, in whole or in part) within five years of the date of the distribution of such stock is treated as "other property." Section 355 does not apply to a transaction which includes a distribution of such stock. See section 356. The stock so acquired is "stock", however, for the purpose of the requirements respecting the distribution of stock of such controlled corporation provided in section 355(a)(1)(D).

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example.

Corporation A has held 85 of the 100 outstanding shares of the stock of Corporation B for more than five years on the date of distribution. Six months before such date, it purchased 10 shares of such stock. If all of the stock of the controlled corporation owned by Corporation A is

distributed, section 355 is not applicable to such distribution since the 10 shares would represent "other property." See, however, section 356. If, however, for proper business reason it is decided to retain some of the stock of Corporation B, then the determination of the amount of such stock which must be distributed under section 355(a)(1)(D) in order to constitute a distribution to which section 355 is applicable must be made by reference to all of the stock of the controlled corporation including the 10 shares acquired six months before such date and the 5 shares owned by others. Similarly, if, by the use of any agency, the distributing corporation acquires stock of the controlled corporation within five years of the date of distribution, for example, where other subsidiary purchases such stock, such stock will be treated as "other property." If Corporation A had held only 75 of the 100 outstanding shares of stock of Corporation B for more than five years on the date of distribution and had purchased the remaining 25 shares six months before such date, neither section 355 nor section 356 would be applicable.

(g) Active businesses.

The rules of section 355(b) and § 1.355-4, relating to active businesses, must be satisfied.

REG. SEC. 1.355-3. NON PRO RATA DISTRIBUTIONS, ETC.

(a) The rule of section 355(a)(1) prescribing that gain or loss will not be recognized applies whether or not the distribution is pro rata with respect to the interests of all the shareholders in the distributing corporation provided all other requirements of section 355 are satisfied. For example, if two individuals, A and B, own all of the stock of Corporation X which operates two active businesses, one business may be transferred to a new corporation in exchange for all of its stock and such stock distributed to

either A or B in exchange for all of his stock of Corporation X. Similarly, if, in the above example, only a part of the stock of the new corporation is transferred to one of the shareholders in exchange for all of his stock of Corporation X and the balance of such stock is distributed to the other shareholder (whether or not such other shareholder surrenders stock in Corporation X), no gain or loss will be recognized. The same rule will be applicable if the stock of an existing controlled corporation is distributed to the shareholders even though such distribution is not pursuant to a plan of reorganization. Section 355 does not apply, however, if the substance of the transaction is merely an exchange between shareholders or security holders of stock or securities in one corporation for stock of securities in another corporation. For example, if two individuals, C and D, each own directly fifty percent of the stock of Corporation M and fifty percent of the stock of Corporation N, section 355 would not apply to a transaction in which C and D transfer all of their stock in Corporation M and Corporation N to a new corporation, P, for all of the stock of Corporation P, and Corporation P then distributes the stock of Corporation M to C and the stock of Corporation N to D.

(b) The stock of the controlled corporation which is distributed may consist of either common or preferred stock. See, however, section 306 with respect to the receipt of preferred stock in a transaction to which section 355 is applicable.

(c) The rule of section 355(a)(1) prescribing that gain or loss will not be recognized applies whether or not the shareholder surrenders stock in the distributing corporation and whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

REG. SEC. 1.355-4. ACTIVE CONDUCT OF A TRADE OR BUSINESS.

(a) A distribution of stock or securities of a controlled corporation is subject to section 355(a) only if:

(1) The distributing corporation and the controlled corporation are each engaged in the active conduct of a trade or business immediately after the distribution of stock or securities of the controlled corporation; or

(2) Immediately before the distribution the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged in the active conduct of a trade or business immediately after the distribution. In connection with the requirement of "no assets" a de minimis rule is applicable.

(3) These rules are illustrated by the following examples:

Example (1). Corporation A, prior to the distribution, operates an active business and owns all of the stock of Corporation B which also is engaged in the active conduct of a business. Corporation A distributes all of the stock of Corporation B to its shareholders, and both continue the operations of their separate businesses. The active business requirement of section 355(b)(1)(A) is satisfied.

Example (2). The facts are the same as in example 1, except that Corporation A transfers all of its assets except the stock of Corporation B to a new corporation in exchange for all of its stock and transfers the stock of both controlled corporations to its shareholders. The active business requirement of section 355(b)(1)(B) is satisfied.

(b)(1) Section 355(b)(2) provides rules for determining whether any corporation is treated as engaged in the active conduct of a trade or business for purposes of ascertaining whether the distributing corporation and the controlled corporation meet the requirements of section 355(b)(1). Under section 355(b)(2)(A), a corporation is treated as

engaged in the active conduct of a trade or business if it is itself engaged in such a trade or business or if substantially all of its assets consist of the stock and securities of a corporation or corporations controlled by it (immediately after the distribution) each of which is engaged in the active conduct of a trade or business. Regardless of whether the determination is based upon a corporation's own conduct of a trade or business or on the basis of its ownership of the stock of a corporation or corporations which conduct a trade or business, such trade or business must have been actively conducted for the five-year period ending on the date of distribution of the stock and securities of the controlled corporation the stock of which was distributed as provided in section 355(b)(2)(B). Furthermore, such trade or business must not have been acquired by either corporation during such five-year period unless it was acquired in a transaction in which gain or loss was not recognized (section 355(b)(2)(C)). In addition, under section 355(b)(2)(D), such business must not have been indirectly acquired during such five-year period by means of the acquisition of control of another corporation in a transaction in which gain or loss was recognized. Thus, section 355(b)(2)(D) requires that during the five-year period during which the trade or business must be actively conducted, such business cannot have been acquired, directly or indirectly, through another corporation by such other corporation or any of its predecessors in interest in a transaction in which gain or loss was recognized in whole or in part.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. In 1956, Corporation B, having cash and other liquid assets and engaged in only one active business, purchases all of the stock of Corporation A, also engaged in a single active business. Later in the same year, Corporation B in a "downstairs" statutory merger merges into Cor-

poration A. In 1958, Corporation A places the assets of the active business formerly operated by Corporation B in a new subsidiary X. A distribution of the stock of Corporation X to the stockholders of Corporation A is not within the terms of section 355, since one of the active businesses had, in effect, been purchased less than five year prior to the distribution.

(3) For the purpose of determining whether such trade or business has been actively conducted throughout the five-year period described in section 355(b)(2), the fact that during such five-year period such trade or business underwent change (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded provided the changes are not of such a character as to constitute the acquisition of a new or different business.

REG. SEC. 1.355-5. RECORDS TO BE KEPT AND INFORMATION TO BE FILED.

(a) Every corporation that makes a distribution of stock or securities of a controlled corporation, as described in section 355, shall attach to its return for the year of distribution a detailed statement setting forth such data as may be appropriate in order to show compliance with the provisions of such section.

(b) Every taxpayer who receives a distribution of stock or securities of a corporation that was controlled by a corporation in which he holds stock or securities shall attach to his return for the year in which such distribution is received a detailed statement setting forth such data as may be appropriate in order to show the applicability of section 355. Such statement shall include, but shall not be limited to, a description of the stock and securities surrendered (if any) and received, and the names and addresses of all of the corporations involved in the transaction.

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Supreme Court of the United States.

OCTOBER TERM, 1971.

No. 71-1123.

JOSEPH V. RAFFERTY AND
MARGARET M. RAFFERTY,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

PETITIONERS' SUPPLEMENTAL MEMORANDUM.

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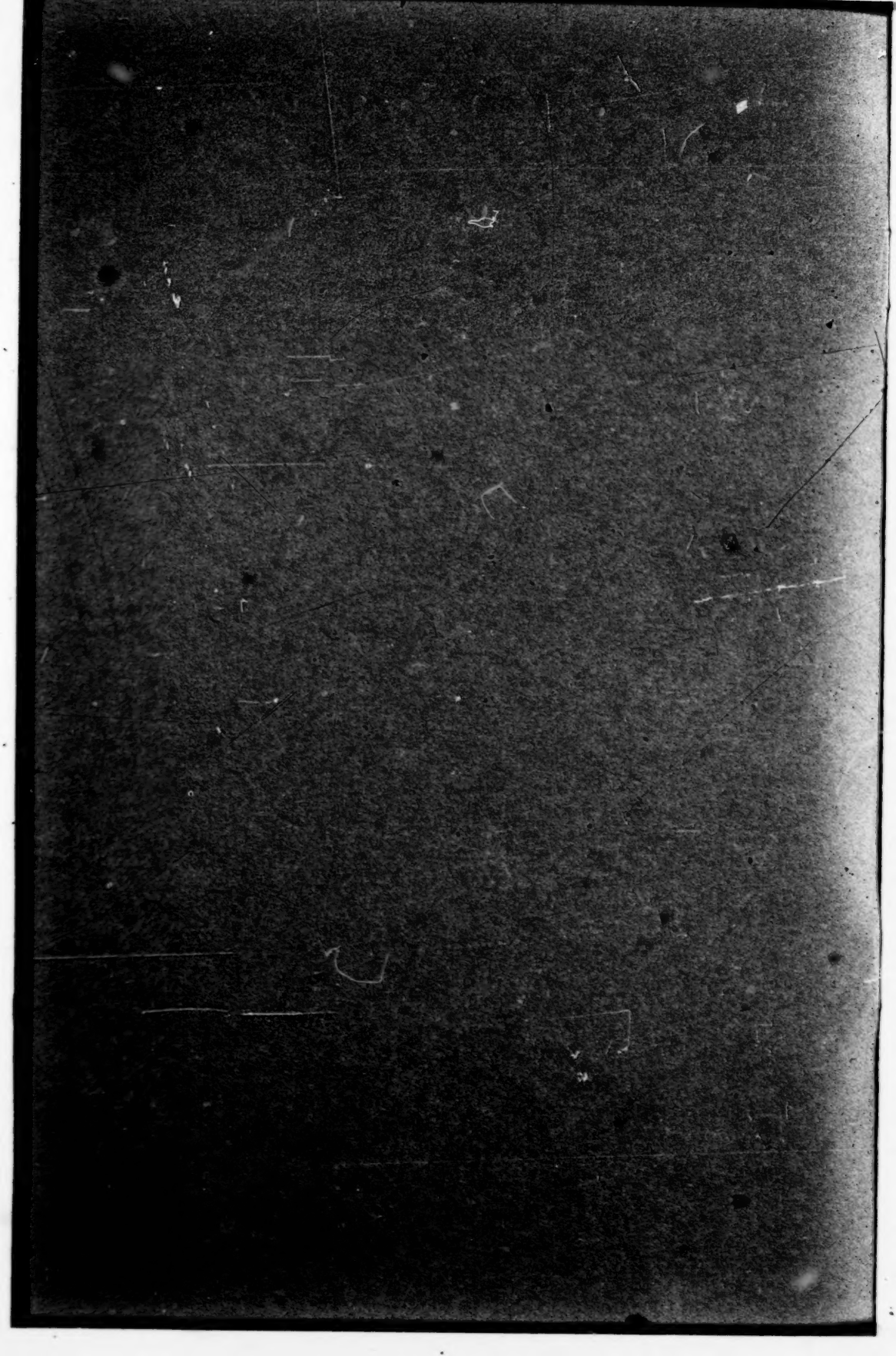

Supreme Court of the United States.

OCTOBER TERM, 1971.

No. 71-1123.

JOSEPH V. RAFFERTY AND
MARGARET M. RAFFERTY,
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

PETITIONERS' SUPPLEMENTAL MEMORANDUM.

Petitioners' petition for a writ of certiorari referred, at pages 9-12, to the case of *King* v. *Commissioner,* 55 T.C. 677 (filed January 28, 1971), then on appeal to the U.S. Court of Appeals for the Sixth Circuit. *King* contains facts substantially similar to the instant case with respect to the issue of what constitutes the "active conduct of a trade or business" within the meaning of section 355 of the Internal Revenue Code of 1954. Counsel for petitioners indicated that the Sixth Circuit might decide the *King* case for the petitioner therein and asked this Court to delay action on the petition in this case until a decision had been reached by the Sixth Circuit.

King v. *Commissioner,* F. 2d , (C.A. 6) decided and filed April 7, 1972 (Appendix), held that a subsidiary corporation formed for the purpose of acquiring, improving and leasing real estate to its parent corporation was engaged in the active conduct of a trade or business. Thus, the *King* case is in direct conflict with the instant case on this issue.

Therefore, petitioners request that this Court take into account the following matters in reaching its decision whether to grant their petition for a writ of certiorari:

1. The Solicitor General has until July 6, 1972 to file a petition for a writ of certiorari in the *King* case. Petitioners herein have no information regarding the Solicitor General's decision whether or not to appeal *King.*

2. Whether or not the Government appeals in the *King* case, there is a direct conflict between the First Circuit in this case and the Sixth Circuit in *King,* on virtually identical facts, on the issue of what constitutes the active conduct of a trade or business within the meaning of section 355 I.R.C.

3. As pointed out in the petition (pp. 6-9), there exists a conflict between the First Circuit in the instant case and the Second Circuit in the case of *Estate of Parshelsky* v. *Commissioner,* 303 F. 2d 14 (C.A. 2, 1962), on similar facts, on the issue of what constitutes a valid business purpose for a transaction coming within the meaning of section 355 I.R.C.

4. The United States Tax Court has indicated that it will follow a Court of Appeals decision which is squarely in point where appeal from its decision lies to that Court of Appeals. *Golsen* v. *Commissioner,* 54 T.C. 742 (1970). Therefore, if this Court does not grant this petition and decide these issues, there would exist the certainty of future unequal tax consequences depending on the geographical situs of the taxpayer.

For the foregoing reasons and for the reasons cited in our petition, petitioners urge this Court to grant the petition for a writ of certiorari to the United States Court of Appeals for the First Circuit.

Respectfully submitted,

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Of Counsel:
DANIEL S. FISCHBACH,
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Appendix.

No. 71-1418

United States Court of Appeals for the SIXTH CIRCUIT.

E. WARD KING, ET AL., *Appellants*,
v.
COMMISSIONER OF INTERNAL REVENUE, *Appellee*.
} APPEAL from the United States Tax Court.

Decided and Filed April 7, 1972.

Before: PHILLIPS, Chief Judge, and PECK and MCCREE, Circuit Judges.

PECK, Circuit Judge. This case involves the income tax liability for the year 1963 of the stockholders of the Mason & Dixon Lines, Inc., a motor common carrier of freight in interstate commerce. The facts of the case are fully set forth in the reported decision of the Tax Court, 55 T.C. No. 69, and disclose that Mason & Dixon, a Tennessee corporation formed in 1934, had been expanding rapidly since 1945 and by 1950 had outgrown its existing terminal facilities. It became apparent that new terminals would have to be constructed. The Interstate Commerce Act prohibited Mason & Dixon from borrowing the substantial funds it needed without prior ICC approval, a complex and extended procedure. Subsidiary corporations were therefore formed

which were not subject to the jurisdiction of the ICC for the purpose of acquiring, improving, and leasing real estate to Mason & Dixon. The three subsidiary corporations involved in this action are Interstate Investment Corp., formed in 1950, Motorways Investment Corp., formed in 1953, and The Regal Corp., formed in 1956. Mason & Dixon owned all outstanding stock until October 4, 1963.

These corporations each served the same function, and each conducted its affairs in an identical manner. As Mason & Dixon required additional facilities, one of the subsidiary corporations would acquire the land, would accept a bid and enter into a contract with a general contractor for the construction of the terminal. In each case, the architect was engaged by Mason & Dixon. The subsidiary corporation would obtain a permanent loan secured by a first mortgage real estate note or a deed of trust to secure the debt on which it was the sole party obligor. Upon completion of the terminal, it was leased to Mason & Dixon.

In 1963, in order to facilitate a merger with Silver Fleet, Inc., an Indiana common carrier of freight, Mason & Dixon reorganized its operations to consolidate all carrier corporations in one group and all non-carrier corporations in another. This was accomplished by distributing all the stock of the three leasing corporations to the stockholders of Mason & Dixon, who then transferred all of this stock to Crown Enterprises, Inc. in exchange for voting stock of Crown, a wholly owned subsidiary of Mason & Dixon which had been formed in 1957 for the purpose of renting automotive equipment. The result of this distribution and exchange was that each of the three leasing corporations now enjoyed greater borrowing power by virtue of the fact that the common parent, Crown, could negotiate for all. The leasing corporations continued to operate in the same fashion as they had prior to the reorganization.

The stockholders reported this receipt of stock in their respective 1963 income tax returns as a transaction in which no gain or loss is recognized under § 355 of the Internal Revenue Code of 1954. The Commissioner determined that this distribution constituted a taxable dividend to the extent of the fair market value of the stock received by each taxpayer, and denied the claimed non-recognition of the distribution. The Tax Court sustained the Commissioner and concluded that the three subsidiary corporations were not engaged in the active conduct of a trade or business for the five year period prior to the date of the distribution, as required by § 355 (b). Having so held, the Tax Court found it unnecessary to reach the Commissioner's alternative arguments that the subsidiaries were not engaged in the active conduct of a business immediately after the distribution and that the transaction had been used principally as a device for the distribution of the earnings and profits of the subsidiaries.[1] The taxpayers have perfected this appeal from the decision of the Tax Court.

Section 355 of the Internal Revenue Code of 1954 provides an exception to the general rule that stock distributions by corporations are taxable to the shareholders. Distributions are so taxed to prevent corporations from moving undistributed income and earnings into the hands of stockholders who can dispose of them at capital gain rates instead of ordinary income rates. Congress recognized that there may be valid business reasons for the distribution of stock, and therefore provided that a distribution may go untaxed if the requirements of § 355 are met.

We start with the findings of the Tax Court that the subsidiary corporations were not shams, that there was no subterfuge, that the leasing corporations were organized to

[1] The other requirements of § 355 are not in issue; nor is any question raised as to the active conduct of a trade or business by Mason & Dixon.

fulfill a valid business need of Mason & Dixon, that the leasing corporations adopted and followed the most advantageous method of doing business, that all rentals paid were customary within the industry and that the stock distribution and reorganization were also entered into for valid business reasons. The record shows that the subsidiary corporations performed all activities necessary to the operation of the real estate leasing business. Each subsidiary purchased land, negotiated with contractors for the construction of terminals, obtained loans, arranged for mortgages in favor of the lender, obtained insurance on the facilities, leased the terminals to Mason & Dixon, collected rentals, made payments of principal and negotiated for additions and alterations to terminals whenever necessary. In performing these and other functions, the subsidiaries acted and were dealt with as independent corporate entities by Mason & Dixon, as well as by contractors and subcontractors, bonding and insurance companies, bankers and other financial institutions, attorneys and local, state and Federal governmental agencies, including the Interstate Commerce Commission and the Internal Revenue Service.

Nevertheless, the Tax Court concluded that the subsidiaries had not actively conducted a trade or business because they performed these activities "in name only," principally because the officers of the subsidiary corporations were also officers of Mason & Dixon, and when these men acquired property, arranged financing and constructed the terminals they were acting on the ultimate behalf of Mason & Dixon. This conclusion was based upon the interdependence between Mason & Dixon and its subsidiaries, and we hold this conclusion to be violative of the principal that, especially for tax purposes, separate corporations, even parent and wholly owned subsidiary, must be treated

as separate entities, no matter how closely they may be affiliated. The separate corporate entity may not be disregarded. *Freedman* v. *United States*, 266 F.2d 291 (6th Cir. 1959). In *Taylor* v. *Commissioner*, 445 F.2d 455 (1st Cir. 1971), the First Circuit said:

> "Although federal courts have, on occasion upheld the Commissioner's disregard of a corporate entity, this has generally been done to prevent unfair tax avoidance. Only in situations where a corporation performs no function but the holding of title to real estate, have courts ignored the corporate entity." 445 F.2d at 457.

It is clear from the Tax Court's opinion that it disregarded the separate entities of the subsidiary corporations and based its conclusion upon the relationship of the subsidiary corporations to the distributing corporation. The record in this case discloses that the subsidiary corporations did far more than merely hold title to the terminal facilities which were leased to Mason & Dixon. In short, the record shows that the leasing corporations engaged repeatedly in construction projects of considerable magnitude, created substantial income producing rental properties and conducted all activities essential to the real estate leasing business. Even though the officers and directors of the leasing corporations were also officers and directors of Mason & Dixon, when they were performing activities in behalf of the leasing corporations they were in fact and in law acting solely for the leasing corporations.

The Tax Court considered that the fact that the leasing corporations had but one paid employee, an accountant, indicated strongly that no activities were being performed by the subsidiaries. However, the record clearly establishes that each subsidiary had four officers and at least four

directors, all of whom rendered substantial services in acting for the subsidiaries.[2]

The Tax Court found that the net lease basis upon which properties were leased to Mason & Dixon represented pure passive income without the concomitant expenditure of money or effort on the part of the lessor. However, the Tax Court also found that the net leases represented the most advantageous method of doing business from the point of view of the leasing corporations, that the leases were bona-fide and of a type customarily used in the industry in long term situations and that the rentals paid were customary in the industry. The leasing of the terminal facilities represented the ultimate objective of the subsidiary corporations, but, as detailed above, it was far from the only activity conducted by them.

The findings of the Tax Court refute any contention that the subsidiaries were sham corporations or were mere contrivances for transferring corporate profits and properties. These corporations were not created to transfer corporate shares or anything of value to the taxpayers, were not terminated when their limited function had been exercised (as in *Gregory* v. *Commissioner*, 293 U.S. 465 (1935)) nor were they formed for the specific purpose of distributing stock upon the expiration of the five year period (as in *Rafferty* v. *Commissioner*, — F.2d — (1st Cir. 1972), hereinafter discussed.)

In direct contrast, these subsidiaries were formed for valid business reasons many years before the transactions in question were contemplated. The distribution of their stock was not even considered until after the Silver Fleet

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[2] Although they were not paid for these services, it is customary that officers and directors serve without compensation unless special provisions have been made. E.g.: *Nichols-Morris Corp.* v. *Morris*, 174 F. Supp. 691, 698 (S.D.N.Y.), appeal dismissed, 272 F.2d 586 (2d Cir. 1959), *Nashville Breeko Block & Tile Co.* v. *Hopton*, 29 Tenn. App. 394, 196 S.W.2d 1010 (1946).

transaction created new business needs for the group (and even then, only after it became necessary to abandon another plan, which would not have involved such a distribution). All transactions, from the formation of the subsidiary corporations to the contested distributions, even to the present operation of the corporations, were designed to conform to ICC regulations. It seems clear that this is exactly the situation intended to be protected by § 355.

The Senate Finance Committee Report states with reference to § 355:

> "Thus, your committee would liberalize present law with respect to the nonrecognition of gain or loss in cases which involved *mere rearrangements* of the corporate structure." S. Rept. No. 1622, 83 Cong., 2d Sess. P. 50. (Emphasis added.)

And Treasury Regulations, § 1.355-2(c) provide that § 355 is to be applied to distributions of the stock or securities of controlled corporations incident:

> "... to such readjustment of corporate structures as is required by business exigencies and which, in general, effect only a readjustment of continuing interests in property under modified corporate forms."

This is precisely what was done in the present case. We can only conclude that the appellants are not attempting to avoid taxation, but only seek tax postponement on unrealized gains in a manner authorized by statute.

The Commissioner contends that the case is governed by Treasury Regulation 1.355-1(c). This regulation provides that a group of activities do not satisfy the active business requirement of § 355 if they are not "independently producing income," even though they may be part of a business operated for a profit. We agree with the First Circuit,

which noted in *Rafferty* that these portions of the regulations are so broadly drawn that they may be used in some cases to defeat the clear legislative intent. Furthermore:

> "The correctness of these regulations is questionable in view of the rejection of the separate business requirement of § 1.355-1(a) in *United States* v. *Marett*, 325 F.2d 28 (5th Cir. 1963) and *Coady* v. *Commissioner*, [33 T.C. 771 (1960), *aff'd.*, 289 F.2d 490 (6th Cir. 1961)]." *Rafferty* v. *Commissioner*, *supra.*

We decline to rest our determination upon these imprecise regulations, and instead rely upon the language of the statute itself and its legislative history. This conclusion makes it unnecessary to pass upon the applicability of the regulations to the factual situation here present, but we express some reservation in this regard.

The Tax Court did not reach the Commissioner's alternative issues concerning the other requirements of § 355, and the Commissioner's brief suggests that in the event of a reversal the case should be remanded to the Tax Court for further findings on these issues. However, a remand is unnecessary if all the evidence is documentary and the appellate court can pass upon the facts as well as the trial court, or if all the facts relied upon to support the judgment are in the record and are undisputed, or if the record as a whole presents no genuine issue as to any material fact. E.g.: *Texas Co.* v. *R. O'Brien & Co.*, 242 F.2d 526 (1st Cir. 1957), *Hazeltine Research* v. *General Motors Corp.*, 170 F.2d 6 (6th Cir. 1948), *McComb* v. *Utica Knitting Co.*, 164 F.2d 670 (2nd Cir. 1947), *Aetna Life Ins. Co.* v. *Meyn*, 134 F.2d 246 (8th Cir. 1943). In considering certain § 355 questions, the Supreme Court stated: "[s]ince the record leaves no disputed issue of fact with respect to this question, we find it proper to decide it here without reference to a tryer

of fact.'" *Commissioner* v. *Gordin,* 391 U.S. 83, 95 n. 8 (1968).

The Tax Court decided the issue of whether the subsidiary corporations were engaged in the active conduct of a trade or business immediately after the distribution when it found that "[a]fter the transactions described above, Interstate, Motorways and Regal carried on in the same fashion as they had theretofore." Since we have determined that the leasing corporations were engaged in the active conduct of a trade or business for five years prior to the distribution, it follows that they were so engaged immediately after the distribution.

The only question remaining to be decided is whether the distribution was used "principally as a device" to distribute the earnings and profits of the subsidiary corporations. We think that the findings of the Tax Court clearly indicate that it was not, and consequently a remand for further deliberation on this point would serve only to unduly protract this litigation.

The Tax Court found that all transactions involved were motivated by valid business reasons. If any change occurred in the tax status, it was simply an incidental result and not a motivating purpose. Furthermore, the distribution could not have been used as a device because the plan of distribution required that the stock received be exchanged immediately for the stock of Crown. Thus the distributed stocks were locked into Crown after the transaction as securely as they had been locked into Mason & Dixon beforehand, and the stockholders were as far removed from the earnings and profits after the distribution as they had been before, and could not abstract any accumulated earnings at capital gain rates.

This purpose is demonstrated also by the exchange of M. & D. Investment stock for stock of Crown. The controlling stockholders already held this stock directly and

were entitled to capital gain treatment on a sale of this stock or a liquidation of the corporation. The fact that they put these earnings and profits out of their reach as part of the transaction here in question shows clearly that their purpose was to build a strong corporate group, not to receive corporate earnings and profits. The deficiencies assessed by the Commissioner result from a transaction in which the taxpayers received no cash or cash equivalent with which to pay tax. Thus, the Commissioner is attempting to tax a gain which has not yet been realized.

In this regard, this case is readily distinguishable from *Rafferty* v. *Commissioner, supra,* in which the First Circuit found that the distribution had been used principally as a device for the distribution of earnings and profits because the motive for the creation of the subsidiary corporation and eventual spin-off was an estate planning motive. The Court reasoned that this in itself does not disqualify the spin-off, but absent a showing that these personal motives were germane to the continuance of the corporate business, such motives were not sufficient to permit non-recognition of the spin-off under § 355(a)(1). The Court noted that these personal motives could have been served equally well by a payment of dividends.

In this case, the motive for the creation of the subsidiary corporations was to fulfill a business need of the parent corporation for motor freight terminals, and to enable the newly created corporations to engage in an income producing activity. The motive for the distribution was to place all non-carrier corporations in a single group, with a common parent in order to accomplish the maximum concentration of financial strength with which to raise additional capital to enable the subsidiaries to construct the terminals needed by Mason & Dixon. The purpose of all transactions was immediate and germane to the continuation of all corporations. If any stockholder purpose was

served, it was a normal purpose in that the corporations in which they owned interests were enabled to expand and to become more profitable.

In *Rafferty*, the consequence of the distribution was that the taxpayer was placed in a position to distribute earnings and profits away from or out of the business, because a sale of the real estate properties could be easily arranged in that the buildings were capable of multiple use. In this case, the terminals were "single-purpose facilities which required specialized equipment and construction." Moreover, the valid business purposes required that the properties be retained in order to augment the corporation's ability to obtain financing, and to enable them to continue and to eventually increase their income producing activities. A sale or liquidation would have impaired the continued operations of Mason & Dixon and its subsidiaries, and would have defeated the purpose of the distribution.

We conclude that these taxpayers are in substantially the same position today as they were before the reorganization. None of the taxpayers have withdrawn or can withdraw any funds under the reorganization as it was planned and executed. In its simplest form, this reorganization constituted a mere realignment of the corporate structure whereby stocks previously owned by Mason & Dixon were transferred to Crown, both of which were owned by the appellants. The undisputed facts as found by the Tax Court place this reorganization within the ambit of § 355, and therefore, the judgment of the Tax Court is reversed, and the cause is remanded to the Tax Court with instructions to enter judgment for the taxpayers in terms consistent with this opinion.

McCree, Circuit Judge (concurring in part and dissenting in part). I agree with the decision of the majority to reverse the judgment of the Tax Court on the question whether the real estate subsidiaries were engaged in the active conduct

of a trade or business for the five years preceding the spin-off. And, I agree that this result necessarily determines the second issue raised by appellee, *i.e.*, whether the controlled corporations and the distributing corporation were engaged in the active conduct of a trade or business after the spin-off.

However, I would remand on the question whether the transaction was used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporations. The fact that there may have been valid business reasons for the spin-off does not, in my opinion, necessarily foreclose a finding that the transaction was used as a "device" for distributing earnings and profits. There may have been other means of separating the real estate operations from the trucking operations that would not have resulted in placing the shareholders of the distributing corporation in a position to realize capital gains on the earnings and profits of the real estate subsidiaries by selling Crown stock while maintaining their interests in the trucking companies. The Tax Court should be permitted to apply its expertise to this question. Moreover, a determination whether a transaction was used principally as a device in this context is a factual one: it entails finding an "ultimate fact" by making certain inferences from the "primary facts," *see NLRB* v. *Hudson Motor Car Company,* 128 F.2d 528, 532 (6th Cir. 1942), a reasoning process not to be undertaken initially by this court but by the Tax Court. *Kisting* v. *Commissioner of Internal Revenue,* 298 F.2d 264, 269 (8th Cir. 1962). Finally, I observe that the majority is deciding the "device" issue without the benefit of briefing and argument by appellee, who urged us to remand for determination of the issues not decided by the Tax Court should we reverse on the first issue. I believe this third issue to be sufficiently complex to justify, at the very least, affording appellee an opportunity to brief and argue it.

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OCTOBER TERM, 1971

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PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Tax Court (Pet. App. 13-32) is reported at 55 T.C. 490. The opinion of the court of appeals (Pet. App. 33) is reported at 452 F. 2d 767.

JURISDICTION

The judgment of the court of appeals was entered on December 6, 1971 (Pet. App. 32). The petition for a writ of certiorari was filed on March 3, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, under the circumstances of this case, the requirements of Section 355 of the Internal Revenue

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Code, which permits shareholders to receive tax free in a spin-off the stock of a controlled corporation, were not satisfied because (1) the stock distribution was principally a device to distribute accumulated profits, and (2), immediately after the distribution, the controlled corporation was not engaged in the active conduct of a trade or business that it had actively conducted for the five preceding years.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of Section 355 of the Internal Revenue Code of 1954 and Sections 1.355–1 and 1.355–2 of the Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix to the petition (pp. 35–48).

STATEMENT

Petitioners owned all of the outstanding shares of Rafferty Brown Steel Company, Inc. (RBS Mass.), a Massachusetts corporation engaged in the processing and distribution of cold rolled sheet and strip steel in Massachusetts. In May 1960, they organized Teragram Realty Company, Inc. (Teragram). In June 1960, RBS Mass. transferred its real estate to Teragram in exchange for all of the latter's outstanding stock. Thereupon Teragram leased back this real estate to RBS Mass. for ten years at an annual rent of $42,000, the lessee to pay taxes on the building and the utilities and to make necessary repairs. In 1962, petitioners also organized Rafferty Brown Steel Company, Inc. (RBS Conn.), a Connecticut corporation which acquired the assets of a general steel products

warehouse in Waterbury, Connecticut. Petitioners owned all of the stock of RBS Conn. In 1965, Teragram purchased some unimproved real estate in Waterbury and built a plant, which it leased to RBS Conn. for a term of fourteen years. Teragram derived all of its income from leasing its properties to RBS Mass. and RBS Conn. (Pet. App. 14–19.)

Petitioner Joseph Rafferty was the guiding force behind the three corporations. He was president and treasurer of Teragram which, while it had no office employees, kept separate books and records and filed separate tax returns for the years in question. (Pet. App. 18, 33 (p. 3).) The earned surplus of RBS Mass. increased from $331,117.97 on June 30, 1959, to $535,395.77 on June 30, 1965. In August 1965, RBS Mass. distributed its Teragram stock to petitioners. With the exception of this distribution, neither RBS Mass. nor Teragram ever paid any dividends. (Pet. App. 18–19.)

The formation of Teragram and the distribution of its stock by RBS Mass. was carried out at the suggestion of petitioners' accountant in connection with the estate planning of petitioner Joseph Rafferty. Petitioners wanted to exclude their daughters from the active management of the steel business, but at the same time, wanted to provide them with property that would produce a steady income. (Pet. App. 19, 33 (pp. 3–4).) After petitioners received the Teragram stock, they were in a position to accomplish both of these purposes by bequeathing the stock of RBS Mass. and RBS Conn. to their sons, and the stock of Teragram to their daughters.

In their income tax report for 1965, petitioners treated the distribution of Teragram stock as a nontaxable transaction under Section 355 of the Internal Revenue Code. The Commissioner determined that it was a taxable dividend on the ground that the requirements of Section 355 had not been met because (1) there was no valid business purpose for the distribution, (2) the distribution was a device to distribute earnings and profits, and (3) Teragram had not actively conducted a trade or business for a five-year period prior to the distribution. (Pet. App. 20–23; 33 (p. 4).)

Both courts below sustained the Commissioner, holding that the requirements of Section 355 were not satisfied and, consequently, that the distribution was taxable to petitioners (Pet. App. 13–33 (pp. 1–10)). The Tax Court based its holding on Teragram's failure to meet the active business requirement (Pet. App. 20, 25–32). The court of appeals agreed with the Tax Court on this point, and alternatively held that petitioners had failed to prove that the distribution was not principally a device to distribute earnings and profits (Pet. App. 33 (pp. 1–10)).

ARGUMENT

The decision below is correct. There is no direct conflict of decisions or any other reason for further review.

1. Generally, a distribution of property by a corporation to a shareholder with respect to its stock is treated as a dividend to the shareholder, taxable to him as ordinary income to the extent of the corpora-

tion's post 1913 earnings and profits. Sections 301 (a) and (c) and 316 of the Internal Revenue Code of 1954. Section 355 of the Code carves out an exception to this general rule by permitting a tax-free spin-off of corporate assets to shareholders in the form of a controlled subsidiary's stock, provided that the several conditions of the statute are met. See *Commissioner* v. *Gordon*, 391 U.S. 83, 88–89.

Both courts below correctly held that the active business requirement of Section 355(b) was not met. Under this requirement, both the distributing and controlled corporations, immediately after the distribution, must be engaged in the active conduct of a trade or business which has been actively conducted throughout the five-year period preceding the distribution. The purpose of this requirement is to prevent the tax-free separation of active and inactive assets into separate corporate entities, thus in effect distributing investment rather than business assets. See S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 50–51; *Coady* v. *Commissioner*, 33 T.C. 771, 777, affirmed *per curiam* on another issue, 289 F. 2d 490 (C.A. 6). Prior to 1965, Teragram's sole function was the holding of property and leasing it back to its parent for a fixed return. Teragram paid no salaries or rent and hired no independent contractors. Its only activities were collecting rent, paying taxes, and keeping separate books—activities appropriately characterized by the court below as being indistinguishable from an investment in securities (Pet. App. 33 (p. 10)). Regardless of any increase in Teragram's activities during 1965, the year of distribution, Teragram was not engaged in

a trade or business that had been actively conducted for a five-year period preceding the distribution. For this reason alone, distribution of its stock was outside the letter and spirit of Section 355 and was a taxable dividend to petitioners.

The court of appeals also concluded that Section 355 was not applicable because the transaction was used "principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both * * *." The distribution amounted to a bail-out of profits by placing saleable investment type assets in the hands of petitioners without otherwise adversely affecting their residual equity interest in RBS Mass. The court of appeals correctly rejected petitioners' argument that their desire to exclude the daughters and sons-in-law from ownership of the business was a proper corporate business purpose under Section 355. See Pet. App. 33 (pp. 4–8).

2. Petitioners erroneously assert conflict (Pet. 8–9, 11), with *Parshelsky's Estate* v. *Commissioner*, 303 F. 2d 14 (C.A.2). That case involved Section 112(b)(11) of the Internal Revenue Code of 1939. As the Second Circuit itself recognized in *Parshelsky* (303 F. 2d at 22), Section 355 of the 1954 Code is substantially different from its predecessor, in that both the distributing and the spun-off corporation must conduct, immediately after the spin-off, an active trade or business that had been conducted for a five-year period prior to the spin-off. Because of the five-year active business requirement prior to the spin-off,

Parshelsky would be decided the same way under Section 355 as the instant case.

As regards the device requirements, there is a difference in approach between the Second and First Circuits. Both courts recognize that business purpose is a factor, although not exclusive, in determining whether a distribution is *principally a device for the* distribution of corporate profits. Under the Second Circuit's view, a noncorporate purpose may be enough to avoid the device requirement, while the First Circuit has here held that an estate planning purpose is not enough. Whether the Second Circuit would reach a different result on these particular facts is entirely speculative.

At the time of filing of the petition herein, the taxpayers' appeal from the decision in *King* v. *Commissioner*, 55 T.C. 677, was pending in the United States Court of Appeals for the Sixth Circuit, and petitioners have relied also upon the possibility of a conflict with that decision (Pet. 9–11). On April 7, 1972, the court of appeals announced its decision in that case, Appendix, *infra*, reversing the decision of the Tax Court. The Court, however, was careful to point out that its decision on substantially different facts involved no disagreement with the decision in the instant case. It found that the leasing subsidiaries in that case had conducted active businesses extending back more than five years in that they had, over the extended period of their existence, acquired land, borrowed funds, engaged repeatedly in construction projects of considerable magnitude, and thereby created substantial income producing properties. It found

further that the distribution of the subsidiaries' stock was not a device for the distribution of earnings and profits because, as found by the Tax Court, all transactions were motivated by valid business reasons in that they were a response to the need for greatly increased credit incident to a marked expansion of trucking operations. The distribution of the subsidiaries' stock was a step in unifying them with another leasing corporation in order to obtain greater aggregate borrowing power, and was germane to the continuation of all the corporations involved.

While the Commissioner does not agree that the borrowing and construction in the name of the subsidiaries in the *King* case constituted the active conduct of a trade or business by the subsidiaries, the greater scope of activity in that case over a period of more than five years constitutes a basis for a different judgment, and eliminates any direct conflict with the instant decision.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JUNE 1972.

APPENDIX

(No. 71-1418)

United States Court of Appeals
for the Sixth Circuit

E. WARD KING, ET AL., APPELLANTS
v.
COMMISSIONER OF INTERNAL REVENUE, APPELLEE

APPEAL FROM THE UNITED STATES TAX COURT

Decided and Filed April 7, 1972

Before: PHILLIPS, Chief Judge, and PECK and McCREE, Circuit Judges.

PECK, Circuit Judge. This case involves the income tax liability for the year 1963 of the stockholders of the Mason & Dixon Lines, Inc., a motor common carrier of freight in interstate commerce. The facts of the case are fully set forth in the reported decision of the Tax Court, 55 T.C. No. 69, and disclose that Mason & Dixon, a Tennessee corporation formed in 1934, had been expanding rapidly since 1945 and by 1950 had outgrown its existing terminal facilities. It became apparent that new terminals would have to be constructed. The Interstate Commerce Act prohibited Mason & Dixon from borrowing the substantial funds

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it needed without prior ICC approval, a complex and extended procedure. Subsidiary corporations were therefore formed which were not subject to the jurisdiction of the ICC for the purpose of acquiring, improving, and leasing real estate to Mason & Dixon. The three subsidiary corporations involved in this action are Interstate Investment Corp., formed in 1950, Motorways Investment Corp., formed in 1953, and The Regal Corp., formed in 1956. Mason & Dixon owned all outstanding stock until October 4, 1963.

These corporations each served the same function, and each conducted its affairs in an identical manner. As Mason & Dixon required additional facilities, one of the subsidiary corporations would acquire the land, would accept a bid and enter into a contract with a general contractor for the construction of the terminal. In each case, the architect was engaged by Mason & Dixon. The subsidiary corporation would obtain a permanent loan secured by a first mortgage real estate note or a deed of trust to secure the debt on which it was the sole party obligor. Upon completion of the terminal, it was leased to Mason & Dixon.

In 1963, in order to facilitate a merger with Silver Fleet, Inc., an Indiana common carrier of freight, Mason & Dixon reorganized its operations to consolidate all carrier corporations in one group and all non-carrier corporations in another. This was accomplished by distributing all the stock of the three leasing corporations to the stockholders of Mason & Dixon, who then transferred all of this stock to Crown Enterprises, Inc. in exchange for voting stock of Crown, a wholly owned subsidiary of Mason & Dixon which had been formed in 1957 for the purpose of renting automotive equipment. The result of this distribution and exchange was that each of the three leasing corporations now enjoyed greater borrowing

power by virtue of the fact that the common parent, Crown, could negotiate for all. The leasing corporations continued to operate in the same fashion as they had prior to the reorganization.

The stockholders reported this receipt of stock in their respective 1963 income tax returns as a transaction in which no gain or loss is recognized under § 355 of the Internal Revenue Code of 1954. The Commissioner determined that this distribution constituted a taxable dividend to the extent of the fair market value of the stock received by each taxpayer, and denied the claimed non-recognition of the distribution. The Tax Court sustained the Commissioner and concluded that the three subsidiary corporations were not engaged in the active conduct of a trade or business for the five year period prior to the date of the distribution, as required by § 355(b). Having so held, the Tax Court found it unnecessary to reach the Commissioner's alternative arguments that the subsidiaries were not engaged in the active conduct of a business immediately after the distribution and that the transaction had been used principally as a device for the distribution of the earnings and profits of the subsidiaries.[1] The taxpayers have perfected this appeal from the decision of the Tax Court.

Section 355 of the Internal Revenue Code of 1954 provides an exception to the general rule that stock distributions by corporations are taxable to the shareholders. Distributions are so taxed to prevent corporations from moving undistributed income and earnings into the hands of stockholders who can dispose of them at capital gain rates instead of ordinary income rates.

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[1] The other requirements of § 355 are not in issue; nor is any question raised as to the active conduct of a trade or business by Mason & Dixon.

Congress recognized that there may be valid business reasons for the distribution of stock, and therefore provided that a distribution may go untaxed if the requirements of § 355 are met.

We start with the findings of the Tax Court that the subsidiary corporations were not shams, that there was no subterfuge, that the leasing corporations were organized to fulfill a valid business need of Mason & Dixon, that the leasing corporations adopted and followed the most advantageous method of doing business, that all rentals paid were customary within the industry and that the stock distribution and reorganization were also entered into for valid business reasons. The record shows that the subsidiary corporations performed all activities necessary to the operation of the real estate leasing business. Each subsidiary purchased land, negotiated with contractors for the construction of terminals, obtained loans, arranged for mortgages in favor of the lender, obtained insurance on the facilities, leased the terminals to Mason & Dixon, collected rentals, made payments of principal and negotiated for additions and alterations to terminals whenever necessary. In performing these and other functions, the subsidiaries acted and were dealt with as independent corporate entities by Mason & Dixon, as well as by contractors and subcontractors, bonding and insurance companies, bankers and other financial institutions, attorneys and local, state and Federal governmental agencies, including the Interstate Commerce Commission and the Internal Revenue Service.

Nevertheless, the Tax Court concluded that the subsidiaries had not actively conducted a trade or business because they performed these activities "in name only," principally because the officers of the subsidiary corporations were also officers of Mason & Dixon, and

when these men acquired property, arranged financing and constructed the terminals they were acting on the ultimate behalf of Mason & Dixon. This conclusion was based upon the interdependence between Mason & Dixon and its subsidiaries, and we hold this conclusion to be violative of the principal that, especially for tax purposes, separate corporations, even parent and wholly owned subsidiary, must be treated as separate entities, no matter how closely they may be affiliated. The separate corporate entity may not be disregarded. *Freedman* v. *United States*, 266 F.2d 291 (6th Cir. 1959). In *Taylor* v. *Commissioner*, 445 F.2d 455 (1st Cir. 1971), the First Circuit said:

> Although federal courts have, on occasion upheld the Commissioner's disregard of a corporate entity, this has generally been done to prevent unfair tax avoidance. Only in situations where a corporation performs no function but the holding of title to real estate, have courts ignored the corporate entity. (445 F.2d at 457.)

It is clear from the Tax Court's opinion that it disregarded the separate entities of the subsidiary corporations and based its conclusion upon the relationship of the subsidiary corporations to the distributing corporation. The record in this case discloses that the subsidiary corporations did far more than merely hold title to the terminal facilities which were leased to Mason & Dixon. In short, the record shows that the leasing corporations engaged repeatedly in construction projects of considerable magnitude, created substantial income producing rental properties and conducted all activities essential to the real estate leasing business. Even though the officers and directors of the leasing corporations were also officers and directors of Mason & Dixon, when they were performing activities

in behalf of the leasing corporations they were in fact and in law acting solely for the leasing corporations.

The Tax Court considered that the fact that the leasing corporations had but one paid employee, an accountant, indicated strongly that no activities were being performed by the subsidiaries. However, the record clearly establishes that each subsidiary had four officers and at least four directors, all of whom rendered substantial services in acting for the subsidiaries.[2]

The Tax Court found that the net lease basis upon which properties were leased to Mason & Dixon represented pure passive income without the concomitant expenditure of money or effort on the part of the lessor. However, the Tax Court also found that the net leases represented the most advantageous method of doing business from the point of view of the leasing corporations, that the leases were bona-fide and of a type customarily used in the industry in long term situations and that the rentals paid were customary in the industry. The leasing of the terminal facilities represented the ultimate objective of the subsidiary corporations, but, as detailed above, it was far from the only activity conducted by them.

The findings of the Tax Court refute any contention that the subsidiaries were sham corporations or were mere contrivances for transferring corporate profits and properties. These corporations were not created to transfer corporate shares or anything of value to the

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[2] Although they were not paid for these services, it is customary that officers and directors serve without compensation unless special provisions have been made. E.g.: *Nichols-Morris Corp.* v. *Morris*, 174 F. Supp. 691, 698 (S.D.N.Y.), appeal dismissed, 272 F.2d 586 (2d Cir. 1959), *Nashville Breeko Block & Tile Co.* v. *Hopton*, 29 Tenn. App. 394, 196 S.W.2d 1010 (1946).

taxpayers, were not terminated when their limited function had been exercised (as in *Gregory* v. *Commissioner,* 293 U.S. 465 (1935)) nor were they formed for the specific purpose of distributing stock upon the expiration of the five year period (as in *Rafferty* v. *Commissioner,* — F.2d — (1st Cir. 1972), hereinafter discussed.)

In direct contrast, these subsidiaries were formed for valid business reasons many years before the transactions in question were contemplated. The distribution of their stock was not even considered until after the Silver Fleet transaction created new business needs for the group (and even then, only after it became necessary to abandon another plan, which would not have involved such a distribution). All transactions, from the formation of the subsidiary corporations to the contested distributions, even to the present operation of the corporations, were designed to conform to ICC regulations. It seems clear that this is exactly the situation intended to be protected by § 355.

The Senate Finance Committee Report states with reference to § 355:

> "Thus, your committee would liberalize present law with respect to the nonrecognition of gain or loss in cases which involved *mere rearrangements* of the corporate structure." S. Rept. No. 1622, 83 Cong., 2d Sess. P. 50. (Emphasis added.)

And Treasury Regulations, § 1.355-2(c) provide that § 355 is to be applied to distributions of the stock or securities of controlled corporations incident:

> * * * to such readjustment of corporate structures as is required by business exigencies and which, in general, effect only a readjustment of continuing interests in property under modified corporate forms.

This is precisely what was done in the present case. We can only conclude that the appellants are not attempting to avoid taxation, but only seek tax postponement on unrealized gains in a manner authorized by statute.

The Commissioner contends that the case is governed by Treasury Regulation 1.355-1(c). This regulation provides that a group of activities do not satisfy the active business requirement of § 355 if they are not "independently producing income," even though they may be part of a business operated for a profit. We agree with the First Circuit, which noted in *Rafferty* that these portions of the regulations are so broadly drawn that they may be used in some cases to defeat the clear legislative intent. Furthermore:

> The correctness of these regulations is questionable in view of the rejection of the separate business requirement of § 1.355-1(a) in *United States* v. *Marett*, 325 F.2d 28 (5th Cir. 1963) and *Coady* v. *Commissioner*, [33 T.C. 771 (1960), *aff'd.*, 289 F.2d 490 (6th Cir. 1961)]. *Rafferty* v. *Commissioner, supra.*

We decline to rest our determination upon these imprecise regulations, and instead rely upon the language of the statute itself and its legislative history. This conclusion makes it unnecessary to pass upon the applicability of the regulations to the factual situation here present, but we express some reservation in this regard.

The Tax Court did not reach the Commissioner's alternative issues concerning the other requirements of § 355, and the Commissioner's brief suggests that in the event of a reversal the case should be remanded to the Tax Court for further findings on these issues. However, a remand is unnecessary if all the evidence is documentary and the appellate court can pass upon

the facts as well as the trial court, or if all the facts relied upon to support the judgment are in the record and are undisputed, or if the record as a whole presents no genuine issue as to any material fact. E.g.: *Texas Co.* v. *R. O'Brien & Co.*, 242 F.2d 526 (1st Cir. 1957), *Hazeltine Research* v. *General Motors Corp.*, 170 F.2d 6 (6th Cir. 1948), *McComb* v. *Utica Knitting Co.*, 164 F.2d 670 (2d Cir. 1947), *Aetna Life Ins. Co.* v. *Moyn*, 134 F.2d 246 (8th Cir. 1943). In considering certain § 355 questions, the Supreme Court stated: "[s]ince the record leaves no disputed issue of fact with respect to this question, we find it proper to decide it here without reference to a tryer of fact." *Commissioner* v. *Gordon*, 391 U.S. 83, 95 n. 8 (1968).

The Tax Court decided the issue of whether the subsidiary corporations were engaged in the active conduct of a trade or business immediately after the distribution when it found that "[after the transactions described above, Interstate, Motorways and Regal carried on in the same fashion as they had theretofore." Since we have determined that the leasing corporations were engaged in the active conduct of a trade or business for five years prior to the distribution, it follows that they were so engaged immediately after the distribution.

The only question remaining to be decided is whether the distribution was used "principally as a device" to distribute the earnings and profits of the subsidiary corporations. We think that the findings of the Tax Court clearly indicate that it was not, and consequently a remand for further deliberation on this point would serve only to unduly protract this litigation.

The Tax Court found that all transactions involved were motivated by valid business reasons. If any change occurred in the tax status, it was simply an

incidental result and not a motivating purpose. Furthermore, the distribution could not have been used as a device because the plan of distribution required that the stock received be exchanged immediately for the stock of Crown. Thus the distributed stocks were locked into Crown after the transaction as securely as they had been locked into Mason & Dixon beforehand, and the stockholders were as far removed from the earnings and profits after the distribution as they had been before, and could not abstract any accumulated earnings at capital gain rates.

This purpose is demonstrated also by the exchange of M. & D. Investment stock for stock of Crown. The controlling stockholders already held this stock directly and were entitled to capital gain treatment on a sale of this stock or a liquidation of the corporation. The fact that they put these earnings and profits out of their reach as part of the transaction here in question shows clearly that their purpose was to build a strong corporate group, not to receive corporate earnings and profits. The deficiencies assessed by the Commissioner result from a transaction in which the taxpayers received no cash or cash equivalent with which to pay the tax. Thus, the Commissioner is attempting to tax a gain which has not yet been realized.

In this regard, this case is readily distinguishable from *Rafferty* v. *Commissioner, supra,* in which the First Circuit found that the distribution had been used principally as a device for the distribution of earnings and profits because the motive for the creation of the subsidiary corporation and eventual spin-off was an estate planning motive. The Court reasoned that this in itself does not disqualify the spin-off, but absent a showing that these personal motives were germane to the continuance of the corporate business,

such motives were not sufficient to permit non-recognition of the spin-off under § 355(a)(1). The Court noted that these personal motives could have been served equally well by a payment of dividends.

In this case, the motive for the creation of the subsidiary corporations was to fulfill a business need of the parent corporation for motor freight terminals, and to enable the newly created corporations to engage in an income producing activity. The motive for the distribution was to place all non-carrier corporations in a single group, with a common parent in order to accomplish the maximum concentration of financial strength with which to raise additional capital to enable the subsidiaries to construct the terminals needed by Mason & Dixon. The purpose of all transactions was immediate and germane to the continuation of all corporations. If any stockholder purpose was served, it was a normal purpose in that the corporations in which they owned interests were enabled to expand and to become more profitable.

In *Rafferty*, the consequence of the distribution was that the taxpayer was placed in a position to distribute earnings and profits away from or out of the business, because a sale of the real estate properties could be easily arranged in that the buildings were capable of multiple use. In this case, the terminals were "single-purpose facilities which required specialized equipment and construction." Moreover, the valid business purposes required that the properties be retained in order to augment the corporation's ability to obtain financing, and to enable them to continue and to eventually increase their income producing activities. A sale or liquidation would have impaired the continued operations of Mason & Dixon and its subsidiaries, and would have defeated the purpose of the distribution.

We conclude that these taxpayers are in substantially the same position today as they were before the reorganization. None of the taxpayers have withdrawn or can withdraw any funds under the reorganization as it was planned and executed. In its simplest form, this reorganization constituted a mere realignment of the corporate structure, whereby stocks previously owned by Mason & Dixon were transferred to Crown, both of which were owned by the appellants. The undisputed facts as found by the Tax Court place this reorganization within the ambit of § 355, and therefore, the judgment of the Tax Court is reversed, and the cause is remanded to the Tax Court with instructions to enter judgment for the taxpayers in terms consistent with this opinion.

McCree, Circuit Judge (concurring in part and dissenting in part). I agree with the decision of the majority to reverse the judgment of the Tax Court on the question whether the real estate subsidiaries were engaged in the active conduct of a trade or business for the five years preceding the spin-off. And, I agree that this result necessarily determines the second issue raised by appellee, *i.e.*, whether the controlled corporations and the distributing corporation were engaged in the active conduct of a trade or business after the spin-off.

However, I would remand on the question whether the transaction was used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporations. The fact that there may have been valid business reasons for the spin-off does not, in my opinion, necessarily foreclose a finding that the transaction was used as a "device" for distributing earnings and profits. There may have been other means of separating the real estate operations from the trucking oper-

ations that would not have resulted in placing the shareholders of the distributing corporation in a position to realize capital gains on the earnings and profits of the real estate subsidiaries by selling Crown stock while maintaining their interests in the trucking companies. The Tax Court should be permitted to apply its expertise to this question. Moreover, a determination whether a transaction was used principally as a device in this context is a factual one: it entails finding an "ultimate fact" by making certain inferences from the "primary facts," *see NLRB* v. *Hudson Motor Car Company*, 128 F.2d 528, 532 (6th Cir. 1942), a reasoning process not to be undertaken initially by this court but by the Tax Court. *Kisting* v. *Commissioner of Internal Revenue*, 298 F.2d 264, 269 (8th Cir. 1962). Finally, I observe that the majority is deciding the "device" issue without the benefit of briefing and argument by appellee, who urged us to remand for determination of the issues not decided by the Tax Court should we reverse on the first issue. I believe this third issue to be sufficiently complex to justify, at the very least, affording appellee an opportunity to brief and argue it.

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Supreme Court of the United States.

OCTOBER TERM, 1971.

No. 71-1123.

JOSEPH V. RAFFERTY AND
MARGARET M. RAFFERTY,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

PETITIONER'S REPLY TO BRIEF IN OPPOSITION.

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The views expressed in the brief for the respondent in opposition distort the issues in this case and necessitate that the following points be discussed:

1. The Government's brief in opposition (pp. 5-6) acknowledges the increase in Teragram's activities in 1964 and 1965, yet concludes that it was not actively conducting a trade or business for five years prior to the distribution of its stock. Teragram started small, acquiring and leasing the East Longmeadow plant in 1960. In 1964 and 1965 it expanded its activities by acquiring, financing, building and leasing a second plant at Waterbury.

The Government's view would allow a company to rise to the status of being actively conducted only after a second series of events. This view is totally out of touch with business reality. A business owning one piece of property, office or store can be as actively conducted as any conglomerate.

2. The Government has obscured the relevance and significance of *Estate of Parshelsky* v. *Commissioner of Internal Revenue*, 303 F. 2d 14 (C.A. 2) on the "active conduct of a trade or business" issue. The Government is correct in stating that section 112(b)(11) of the 1939 Code (Pet. App. 37) did not require the active conduct of a trade or business for five years prior to distribution and that the taxpayers in *Parshelsky* could not have met the five year test. However, the phrase "the active conduct of a trade or business" and its legal definition is the same in both the 1939 and 1954 Codes. The Second Circuit held that ". . . It is clear that acting as lessor of real property which is rented to others can constitute a trade or business. . . . Absent the limitations of the § 355 regulations, acting as lessor to a related corporation can also constitute an active trade or business within the meaning of § 112(b)(11)." 303 F. 2d 14, at 22.

Thus, there is a definite conflict on similar facts on this issue between the First Circuit on the one hand and the Second Circuit in *Parshelsky* and the Sixth Circuit in *King, infra,* on the other.

3. The Government recognizes (Brief, p. 7) the distinction in the views of the First and Second Circuits on the issue of whether a noncorporate (*i.e.*, estate planning) purpose is a valid business purpose in determining whether a distribution is principally a device for the distribution of corporate profits (Brief, p. 7). Thus, the Government seems to agree that a conflict exists on this issue between *Parshelsky, supra,* and the instant case.

4. The Government attempts to distinguish *King* v. *Commissioner of Internal Revenue,* F. 2d (1972) (Pet. Supp. Memo. App.), on the basis of "substantially different facts." (Brief, p. 7.) But what is significant, and overlooked by the Government, is the character of the activities of the subsidiaries in *King,* and not their duration or absolute number. The fact that they had been in business for more than five years is irrelevant under the statutory test. The number of construction projects is not important. What is critical is the character of the activities conducted in each project. The activities of the *King* subsidiaries on each project were substantially identical with Teragram's activities. Here again, a conflict in Circuits exists.

The Government has distorted the *Parshelsky* and *King* decisions and has attempted to obscure the obvious conflicts with the instant case. Therefore, the need for review by this Court is imperative.

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